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 COMMISSION STAFF

MARCH 19, 2004

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I. INTRODUCTION

1 On March 12, 2004, Commission Staff submitted its Post-Hearing Brief in support of three recommendations in this proceeding. First, Staff recommends an adjustment to Tenaska power supply costs in order to implement the Commission's 19th and 20th Supplemental Orders in the Prudence Review. Those Orders set the avoided cost of a Company-built combined cycle combustion turbine as a cap for allowable costs over the life of the contract. Staff's adjustment eliminates Tenaska costs that exceed that cap.

2 Second, Staff recommends an adjustment to fuel costs for Tenaska and Encogen. When the contracts were restructured, the Company had information upon which it could have adopted a long-term strategy to protect for ratepayers the savings the Company itself claimed would justify the significant cost of the buy-outs. The Company, instead, adopted a strategy to maximize short-term earnings for shareholders. The Company was imprudent to do so. Staff's adjustment holds ratepayers harmless for that imprudence and the unreasonable fuel costs that followed. If the Commission accepts this adjustment, Staff's Prudence Review adjustment is unnecessary because Tenaska costs are reduced below the avoided cost cap established in the Prudence Review.

3 Third, the contract to acquire partial ownership of Frederickson allows the Company to terminate the purchase if the Commission does not authorize full rate

recovery of the purchase. Staff recommends that the Commission find this "regulatory out" clause inconsistent with the public interest and sound regulatory policy.

4 The Post-Hearing Brief of Staff addressed all of the arguments raised by the Company in its Initial Brief. Thus, Staff's Reply Brief highlights the significant points supporting Staff's recommendations. We also include a brief word on the gas price forecast debate.

II. ARGUMENT

A. The Commission Should Adopt Staff's Tenaska Adjustment to Implement the Prudence Review Order

5 Staff recommends an adjustment to the cost of power of Tenaska in determining baseline power costs for both the PCA deferral period and the PCORC rate period. Staff's adjustment is necessary to ensure that the cost of Tenaska does exceed the amount permitted by the Commission's Prudence Review Orders.

6 The Company argues that the Staff adjustment is inconsistent with the plain language and historical application of those Orders.[1] Both arguments should be rejected.

[1] PSE Initial Brief at 18-26.

1. The Company's Argument Rests on a Mischaracterization of the Prudence Review Orders

7 The Company's fundamental argument is that the Prudence Review Orders "cited a specific imprudent act by Puget – the failure to properly analyze the value of dispatchability – and disallowed a specific percentage of 'net contract costs' representing the value of that dispatchability."[2]

8 The Company mischaracterizes the Prudence Review Orders in two essential ways. First, the Company implies that Puget's failure to consider dispatchability was the only basis upon which the Commission found Puget imprudent in acquiring Tenaska, March Point Phase II, and Sumas.[3] Dispatchability, however, was *not* the only factor that Puget failed to evaluate. The Commission provided a multi-faceted list of items that Puget ignored:

> Thus, the formal competitive bidding rules and results of Commission-approved bids may provide useful information, but they are not dispositive in determining the reasonableness or prudence of these acquisitions. Other evidence needs to be considered. *Other evidence may include the appropriate avoided cost, dispatchability, transmission impacts, building options, and financial and rate impacts*, as we stated in the Eleventh Supplemental order. The record shows that the company did not evaluate the contract process using such evaluation criteria.[4] (Emphasis added.)

9 Thus, Puget was imprudent not only because it failed to evaluate dispatchability. It was imprudent also because it failed to compare Tenaska, March

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[2] PSE Initial Brief at 21, ¶ 75.

[3] These three resources were grouped together because they were all acquired outside of a Commission-approved competitive bidding process. Ex. 82 at 22 (19th Supplemental Order).

[4] *Id.* at 24

Point Phase II, and Sumas to the Company's avoided cost, which, the Commission held, was represented by the self-build option of a combined cycle combustion turbine ("CCCT").[5]

10 The Company also mischaracterizes the Prudence Review Orders by arguing that the disallowance represents the value of dispatchability. In fact, the disallowance ordered by the Commission did not represent the value of dispatchability. It represented the amount paid by Puget above the avoided cost of the Company-built CCCT:

> If [Puget] had correctly analyzed its avoided costs to purchase rates which properly valued the two specific projects, as compared to a company built CCCT, it would not have agreed to purchase at the prices it paid.[6]

11 The avoided cost of the Company-built CCCT was not only the relevant standard to evaluate the acquisition of Tenaska, March Point Phase II, and Sumas. The Commission also stated that the avoided cost of a Company-built CCCT would set the ceiling for the power supply costs that the Company could recover over the terms of those contracts:

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

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[5] *Id*.
[6] *Id*. at 32.

the properly adjusted avoided cost is lower than the price Puget paid for the contracts.[7] (Emphasis added.)

12 The Commission then "properly adjusted" the avoided cost of the Company-built CCCT through Public Counsel's dispatchability model using Puget's estimate of variable costs saved per kilowatt hour of dispatch. All costs that exceeded that adjusted avoided cost cap were disallowed. This resulted in adjustments for Tenaska and March Point Phase II, but no adjustment for Sumas.[8]

13 The absence of an adjustment for Sumas is an important point that underscores the defect in PSE's interpretation of the Prudence Review Orders. If, as PSE claims, the Tenaska disallowance represented the value of dispatchability, then there would have been an adjustment in the Prudence Review for Sumas because Puget failed to consider dispatchability in that acquisition. No adjustment, however, was ordered since the cost of Sumas did not exceed the Company's adjusted avoided cost.[9]

14 In sum, the Commission reviewed many options in the Prudence Review that would have resulted in a much larger disallowance for the Company's imprudent acquisition of Tenaska. The Commission chose the most conservative option in order to minimize the impact on the Company's bottom line.[10] However, the Commission

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[7] *Id*. at 24-5.
[8] *Id.* at 32.
[9] *Id*.
[10] *Id.* at 33.

also crafted that disallowance by comparing the cost of the Tenaska contract with the avoided cost of a Company-built CCCT, adjusted for the value of dispatchability.

15 Staff's adjustment in this case merely does the same: it compares the cost of the restructured Tenaska contract to the avoided cost that Puget failed to evaluate in the Prudence Review and disallows costs that exceed that cap.

2. The Company Ignored the Opportunity to Reopen the Prudence Review Disallowance

16 The Company claims that, even if the Prudence Review Orders imposed a cap, the 1997 restructuring of the Tenaska contract eliminated any possible basis for thereafter applying such a cap.[11] The Company's argument relies on testimony of Staff witness Mr. Schooley that the cap "can be reopened" if the Tenaska contract is reformed.[12]

17 Mr. Schooley's testimony does nothing more than echo the Commission's 20th Supplemental Order in the Prudence Review. The Commission stated in that Order that a contract amendment would not reopen the Tenaska disallowance until PSE convinces the Commission that a change is warranted:

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[11] PSE Initial Brief at 23-24. The Company also claims that the Staff interpretation of the Prudence Review Orders is inconsistent with prior applications of the Tenaska disallowance. PSE Initial Brief at 22-23. Staff demonstrated previously that prior applications of the Tenaska disallowance are irrelevant to the pending case since those cases either predated the Tenaska restructuring or resulted in "black box" settlements that did not create precedent or agreement on any particular issue. Staff Post-Hearing Brief at 9-10.

[12] Tr. 502: 14-17 (Schooley).

> The Commission has made its final decision on the contract disallowance. If Puget amends the contract, it may later present its results and suggested action.[13]

18 The Company admits that it could have petitioned the Commission to reopen the prudence disallowance at the time it restructured the Tenaska contract.[14] It did not do so then or at any later time. Nor was it the responsibility of any other party to suggest any change to the disallowance even if such an opportunity was presented.

19 Thus, if a cap existed at the time the Tenaska contract was restructured, then that cap still exists today. The Company cannot complain when Staff seeks to enforce the cap consistent with the Commission's Prudence Review Order.

3. Conclusion

20 The Company concludes its challenge to Staff's Tenaska Prudence Review disallowance by stating that it would be unfair to impose "massive financial penalties" on PSE in this proceeding.[15] However, no evidence of such penalties was ever presented beyond the nebulous statement that the impact of the Staff adjustment is "difficult to quantify, but it is likely that the credit rating and earnings of the Company would be adversely impacted."[16]

21 More important, the Company believes that it is fair for PSE to recover costs that far exceed the cost of a contract that was not only found to be imprudent when it was

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[13] Ex. 83 at 20 (20th Supplemental Order).
[14] PSE Initial Brief at 24, ¶ 81.
[15] PSE Initial Brief at 25, ¶ 84.
[16] Ex. 220 at 11: 26-27 (Story). The Company makes similar statements, again with no evidentiary support, regarding Staff's fuel cost adjustment for Tenaska and Encogen. PSE Initial Brief at 41, ¶ 130.

first entered and could have resulted in a much larger disallowance than was actually ordered, but also was mismanaged after its reformation. Such a result does not meet any test of fairness known to Staff.

B. The Commission Should Adopt Staff's Fuel Cost Adjustment for Tenaska and Encogen

1. Staff's Adjustment Disallows Unreasonable Fuel Costs Even if the Company's Management of the Contracts Was Prudent

22 The Company disputes all claims that it did not carry its burden to prove that it prudently managed the fuel supply for Tenaska and Encogen after the contracts were restructured.[17] The prudence issue, however, is not necessarily determinative despite its importance and the considerable attention that it garnered in this case. With respect to fuel costs for Tenaska and Encogen, the Commission stated that:

> The Company's actions in purchasing the gas sales contract, *managing the cost of gas*, and restructuring the power purchase agreement is subject to review in future rate proceedings; the Company bears the burden of proof

[17] The Company also criticizes the parties for not making specific accusations of unreasonable and imprudent behavior by PSE at any particular point in time. PSE Initial Brief at 26, ¶ 87. Of course, no such detailed accusations by other parties are legally required since the burden of proof is on PSE and only PSE to demonstrate that its proposed rates are just and reasonable. RCW 80.04.130(4).

Moreover, after Staff's direct case was filed on January 30, 2004, the Company provided additional information in discovery and rebuttal testimony. That additional evidence included considerable detail of the Company's management of the fuel supply for Tenaska and Encogen. This evidence is discussed at length in Staff's initial brief and will only be summarized here. The evidence demonstrates clearly that PSE imprudently managed the contracts by adopting a strategy that elevated short-term shareholder profits over long-term ratepayer benefits even though those benefits were the express justification PSE gave for the accounting petitions.

in any such proceeding regarding these matters. Any costs determined to be *unreasonable or* imprudent in such proceedings are subject to disallowance.[18] (Emphasis added.)

23 Thus, even if the Commission found that the Company *was prudent* in managing the fuel supply for Tenaska and Encogen, the Commission should still examine whether the resultant fuel costs *are unreasonable* for recovery in rates.

24 Staff submits that the fuel costs the Company requests in this case are unreasonable because the Company's management decisions, whether or not they were prudent, denied ratepayers the savings anticipated by PSE for the benefit of ratepayers. Staff's fuel cost adjustment ensures that these unreasonable fuel costs are disallowed by providing ratepayers their equitable share of those savings.

2. Staff's Conclusion That the Company Was Imprudent is Based on Information That Was Available and Known to PSE

25 The Company alleges that Staff uses the "luxury of hindsight" to criticize PSE's management of the fuel supply for Tenaska and Encogen.[19] Nothing could be further from the truth. In fact, Staff reviewed information that was known by the Company from the time the Company restructured the contracts until the Western Power Crisis. This information was discussed exhaustively in Staff's Post-Hearing Brief. It falls generally into the following categories.

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[18] Ex. 283C at 37: *In the Matter of the Petition of Puget Sound Energy, Inc.*, Order at 6, Docket No. UE-971619 (1997); Ex. 284C at 20: *Petition of Puget Sound Energy, Inc.*, Order at 4, Docket No. UE-991989 (1999).

[19] PSE Initial Brief at 27-29.

26 First, Staff reviewed the economic analyses presented by the Company to support the accounting petitions. Those analyses were based on actual and available price quotes for long-term fuel contracts that would produce the significant savings the Company expected to achieve in order to offset the cost of the regulatory assets.[20]

27 Second, Staff reviewed evidence of then-recent spot market activity.[21] That evidence demonstrated that spot market prices were volatile immediately preceding the contract restructurings and had even spiked to levels above long-term contract prices during the first few years after the buy-outs. Staff would have liked to review information about the variability of those long-term contract prices or the significance of any "premiums" the Company alleged for long-term contracts. However, Staff could not review such information because it was never produced or analyzed by PSE.

28 Third, Staff reviewed information about the impact of the contract restructurings on the Company's stranded cost exposure. That information demonstrated that the Company knew the contract buy-outs presented PSE the clear opportunity to significantly reduce stranded costs by almost $400 million.[22]

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[20] The long-term price quotes for the Tenaska restructuring came from AIG Trading, JP Morgan, J. Aron and Engage Energy. Ex. 283C at 5, ¶ 8 and at 13-14, lines 5. The Encogen restructuring also assumed long-term prices for replacement gas. Ex. 284C at 4, ¶ 6 and at 10, line 33. These and other aspects of the Company's accounting petitions are detailed at pages 15-22 of the Post-Hearing of Staff.
[21] Ex. 45 at 18; Ex. 61. *See also* Staff Post-Hearing Brief at 40-41.
[22] Ex. 65 at 26.

29 Finally, Staff reviewed reams of information produced by the Company's Risk Management Committee.[23] That information demonstrated that the Risk Management Committee and the Company's outside consultants warned repeatedly and clearly that the Company's chief decision-makers not rely on short-term markets for fuel supply given the risk, uncertainty and volatility of those markets. The Company, however, rejected that advice. The information also demonstrated that the Company's risk management controls were deficient following the buy-outs, as admitted readily at the time by PSE itself.

30 The issue then becomes what strategy the Company adopted to manage the fuel supply for Tenaska and Encogen in light of the information that was available and known to PSE at the time the Company restructured the underlying contracts. That issue is important not only for the time period when the contracts were restructured, but also later time periods when other fuel management opportunities were lost because of earlier management decisions.

3. The Company's Gas Timeline is Hindsight Justification for an Imprudent Fuel Procurement Strategy

31 The Company focuses its Initial Brief upon the "Gas Timeline" that Mr. Gaines discussed in his rebuttal testimony.[24] A long recitation is then given of the history of the Company's fuel management decisions from the time of restructuring until the

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[23] Exs. 63C and 77C. *See also* Staff Post-Hearing Brief at 28-36.

[24] PSE Initial Brief at Attachment A and Ex. 51.

present.[25] Particular attention is drawn to the state of uncertainty the Company claims it faced in the natural gas and electricity industries.

32 Evidence of recent fuel management activity, however, is irrelevant to this rate case since the Company's earlier decisions had already resulted in lost opportunities to satisfy the economic analyses presented originally to the Commission. The damage had already been done and could not be remedied by PSE's recent risk management practices and procedures.[26]

33 Moreover, the competitive pressures and uncertainties that PSE *now* claims justified its fuel supply decisions had to have been considered by PSE when it requested permission to book the regulatory assets in the first place.[27] The Company cannot now claim that those same circumstances precluded it from achieving the savings that justified the buy-outs in the first place.

34 Most important, the Gas Timeline is itself nothing more than hindsight justification for the fuel management decisions made in fact by the Company. The record is clear that the Company adopted a strategy to manage the fuel supply for Tenaska and Encogen in spot and near-term markets.[28] The record is also clear that PSE adopted that strategy specifically and knowingly to maximize earnings for

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[25] PSE Initial Brief at 31-40.

[26] *See* Staff Post-Hearing Brief at 36-37. Thus, the Company is just flat wrong when it states: "the gas purchasing and hedging decisions that the Company performed in the years following the Tenaska buy-out have no lingering effect on the PCA period or the PCORC period." PSE Initial Brief at 41, citing Tr. 324: 24 – 325: 13 (Gaines).

[27] *See* Staff Post-Hearing Brief at 38-39.

[28] Tr. 323 (Gaines).

shareholders during the rate plan irrespective of the harm such an approach may, and did in fact, engender for ratepayers after the rate plan.[29]

35 In essence, the Company possessed information upon which it could have adopted a fuel supply strategy to satisfy the economic analyses the Company presented to justify the contract buy-outs.[30] The Company, however, purposefully rejected that strategy in favor of other goals that were never presented to the Commission. That decision resulted in the high fuel prices the Company now seeks to recover in this proceeding.

36 Staff submits that the strategy PSE adopted for fuel supply to Tenaska and Encogen was imprudent. Staff's fuel cost adjustment protects ratepayers from the unreasonable costs that resulted.

C. The Company Failed to Rebut Staff's Recommendation Regarding the Regulatory Approval Clause of the Frederickson Contract

37 Staff explained previously and in detail its recommendation that the Commission find that the "WUTC Approval" clause of the Frederickson contract is

[29] Clear evidence of this strategy is discussed at length at pages 24-35 of Staff's Post-Hearing Brief. In general, the strategy was implemented by PSE: (1) tying its fuel supply decisions to annual budget forecasts; (2) using Tenaska as a "heat rate play;" and (3) rejecting the advice of outside experts and its own Risk Management Committee to avoid gas purchases in spot markets.

[30] The Company argues that it never guaranteed the savings presented by the accounting petitions. PSE Initial Brief at 29-30. The argument is a red herring. The issue is not whether the Company promised the savings. Rather, the issue is whether the Company adopted a fuel management strategy reasonably designed to protect the savings that justified the cost of the buy-outs. The evidence demonstrates that PSE did not adopt such a strategy. The Commission and Staff did understand that the Company would drive the gas cost "to market" and that the savings could fluctuate based on market prices. However, it is ludicrous and disingenuous for the Company to suggest that the Commission approved the accounting petitions expecting the Company to adopt a strategy that would nullify the very basis for that approval. *See also* Post-Hearing Brief of Staff at 42-44.

inconsistent with the public interest and sound regulatory policy.[31] In short, the clause violates the Company's statutory obligations to provide safe, adequate and efficient service at fair, just, reasonable and sufficient rates. RCW 80.28.010(1) and (2). The clause violates the Company's statutory burden to prove that its resource acquisitions produce just and reasonable rates. RCW 80.04.130(4). And, the clause may affect the solicitation process and bid prices for new resources.

38 None of the arguments presented by PSE rebut Staff's concerns.[32] The simple fact is that the Company negotiated this provision to eliminate regulatory risks that belong on no one else but the Company. The Company also failed to show that it faces unreasonable financial and market risks that necessitated the WUTC Approval clause. In fact, the Company agreed that a vertically integrated utility like PSE faces reduced risks in the current environment.[33]

39 Finally, the Company persists in arguing that the WUTC Approval clause resulted in a price decrease for the acquisition of Frederickson.[34] The argument misses the point. The record is clear that the seller was "concerned" about the length of time to process this rate case and that its concern would have been eliminated if the clause did not exist.[35] Thus, the clause unnecessarily places the Commission in

[31] Post Hearing Brief of Staff at 48-52.
[32] Initial Brief of PSE at 13-15.
[33] Tr. 112: 4-15 (Markell).
[34] Initial Brief of PSE at 14, ¶ 46.
[35] Ex. 184HC at 2; Ex. 288.

the position of trying to analyze how the seller's concern impacted the purchase price.

40 Moreover, the WUTC Approval clause delayed PSE's ownership of its share of the facility. That delay meant that PSE could not sell power from Frederickson to retail customers or into secondary wholesale markets before the facility was "included in rates." Those lost revenues likely had value far above any price reduction that PSE may have negotiated.

D. A Closing Word on Gas Price Forecasts

41 There are two points to be made on the gas price forecast issue. First, in its rebuttal to ICNU, the Company indicates that Staff adopted the NYMEX-based gas price forecast for fuel purchases for Frederickson.[36] That is true. However, Staff also clarified that gas price forecasts are not significant to Staff's case, since the bulk (81%) of PSE's gas supply is purchased for Tenaska and Encogen, and Staff adjusted the normalized cost of that supply using the fixed gas prices available to PSE at the time the contracts were restructured. But, forecasting gas prices will become significant as Frederickson and other natural gas turbines become a larger part of PSE's resource portfolio.[37]

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[36] Initial Brief of PSE at 44, ¶ 137.
[37] Post-Hearing Brief of Staff at 47, ¶¶ 103-104.

42 Thus, Staff's adoption of the NYMEX gas price projections for fuel purchases other than Tenaska and Encogen was only for purposes of this case.[38] It may yet be appropriate to consider other factors in determining a normalized fuel cost for ratemaking purposes. The parties will be able to devote necessary time and effort to that issue in a future general rate case or Power Cost Only Rate Case.[39]

43 Second, ICNU discusses the PCA particularly with respect to the sharing mechanism above the $40 million cumulative cap that the Company has already exceeded.[40] Thus, as ICNU states, any new costs above the baseline will be paid 99% by ratepayers and 1% by PSE.

44 This discussion is presented in support of ICNU's position that rates should be based on normalized gas costs, rather than the projections proposed by the Company. If ICNU's point is that the Commission must determine the appropriate normalized gas cost for ratemaking purposes, Staff agrees and it has recommended a course of action that will allow the Commission to do so, while reserving the gas price forecast issue for a later proceeding.

45 If, however, ICNU means to set the baseline at an artificially low level to avoid the 99%/1% sharing mechanism, then Staff disagrees. Manipulating the PCA in that

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[38] Tr. 537 (McIntosh).
[39] Tr. 538-41 (McIntosh).
[40] Initial Brief of ICNU at 7-10.

manner would violate the purpose of the mechanism and the intent of the parties that designed the mechanism.

III. CONCLUSION

46 For the reasons set forth above, the Commission should adopt Staff's recommendations in this proceeding.

DATED This 19th day of March, 2004.

Respectfully submitted,

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