[Service Date April 7, 2004]

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	
Complainant,	)	DOCKET NO. UE-031725
v.	)	ORDER NO. 12
PUGET SOUND ENERGY, INC.,	)	GRANTING REGULATORY APPROVALS FOR FREDRICKSON I ACQUISITION; RESOLVING DISPUTED GAS PRICE ISSUE
Respondent.	)	

SYNOPSIS: The Commission grants Puget Sound Energy, Inc., such regulatory authority as the Company requires to complete its acquisition of a 49.85 percent interest in the Frederickson I natural gas fired generation project, including approval of the acquisition as having been prudently made at reasonable cost. The costs associated with the acquisition, including projected baseline gas costs for the rate period, are approved for recovery through rates. The Commission reserves determination of issues related to Tenaska and Encogen to a subsequent order, to be promptly entered in this proceeding.

SUMMARY

1 **PROCEEDINGS:** On October 24, 2003, Puget Sound Energy, Inc. (PSE), filed revisions to its currently effective Tariff WN U-60, designated as Twenty Fifth Revised Sheet No. 95, and Original Sheet Nos. 95-a through 95-e. This filing is a proposal to change PSE's rates recovering the cost of power, as a result of its decision to purchase a new generating resource, and for other reasons. The Commission entered its Complaint and Order Suspending Tariff Revisions; Instituting Investigation; and Authorizing Discovery on October 29, 2004.

2 PSE, by its Motion For Expedited Procedural Schedule, requested Commission action by April 2004, principally to provide sufficient time in advance of the June 17, 2004, closing deadline for the Fredrickson I transaction to accomplish "various pre-closing matters" and allow PSE to "gain certainty with respect to this resource acquisition" and "receive energy and capacity from the Fredrickson I facility as soon as possible."[1] The Commission established an expedited schedule consistent with PSE's Motion.

3 The Commission conducted evidentiary hearings before Chairwoman Marilyn Showalter, Commissioner Richard Hemstad, Commissioner Patrick J. Oshie, and Administrative Law Judge Dennis J. Moss on February 23-26, 2004. The parties filed initial briefs on March 12, 2004, and reply briefs on March 19, 2004.

4 **PARTY REPRESENTATIVES:** Todd G. Glass, Heller Ehrman White & McAuliffe LLP, Seattle, Washington, represents PSE. S. Bradley Van Cleve and Matthew W. Perkins, Davison Van Cleve, Portland, Oregon, represent the Industrial Customers of Northwest Utilities. Norman Furuta, Department of the Navy, represents the Federal Executive Agencies. Michael Alcantar and Donald Brookhyser, Alcantar & Kahl LLP, Portland, Oregon, represent the Cogeneration Coalition of Washington (CCW). Simon ffitch, Assistant Attorney General, Seattle, Washington, represents the Public Counsel Section of the Washington Office of Attorney General. Robert C. Cedarbaum, Senior Assistant Attorney General, Olympia, Washington, represents the Commission's regulatory staff (Commission Staff or Staff).[2]

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[1] Puget Sound Energy, Inc.'s Motion for Expedited Procedural Schedule Consistent With Settlement Stipulation, Docket No. UE-031725 (filed October 24, 2004).

[2] In formal proceedings, such as this case, the Commission's regulatory staff functions as an independent party with the same rights, privileges, and responsibilities as any other party to the proceeding. There is an "*ex parte* wall" separating the Commissioners, the presiding ALJ, and the Commissioners' policy and accounting advisors from all parties, including Staff. *RCW 34.05.455.*

5 **COMMISSION DECISIONS:** The Commission finds and concludes that PSE's acquisition of an interest in Fredrickson I is prudent and that the associated costs PSE seeks to include in rates are reasonable. The Commission's determination that the costs are reasonable turns, in part, on our determination that PSE's methodology used to determine an estimated fuel price for the PCORC rate period is acceptable for purposes of this proceeding.

6 The Commission reserves for further order in this proceeding its resolution of the disputed issues concerning whether there should be a cost disallowance with respect to PSE's Tenaska and Encogen resources. The Commission anticipates that it will enter a subsequent order determining those issues by April 30, 2004, barring unforeseen circumstances.

MEMORANDUM

I. Background and Procedural History

7 The Commission resolved PSE's last general rate case in June 2002 by approving and adopting an unopposed Settlement Stipulation that resulted from a collaborative process among numerous parties.[3] The Settlement Stipulation established a power cost adjustment (PCA) mechanism designed to enhance the Company's financial stability by addressing concerns associated with potentially volatile wholesale power markets and fluctuations in hydropower availability due to uncertain weather conditions. In addition to providing that PSE may file

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[3] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Docket Nos. UE-011570 and UG-011571 (consolidated), Twelfth Supplemental Order: Rejecting Tariff Filing; Approving And Adopting Settlement Stipulation Subject To Modifications, Clarifications, And Conditions; Authorizing And Requiring Compliance Filing (June 20, 2002); *Id.* Fifteenth Supplemental Order Granting Application for Approval of Amendments to Power Cost Adjustment Mechanism in Compliance with Twelfth Supplemental Order (May 13, 2003).

annually to adjust for power cost variances, the PCA allows PSE to initiate a power-cost-only proceeding to add new resources to the Power Cost Rate. In either case, the Company must submit a Power Cost Only Rate filing proposing such change. Any such filing must be accompanied by testimony and exhibits that include the following:

- Current or updated least cost plan
- Description of the need for additional resources (as applicable)
- Evaluation of alternatives under various scenarios
- Adjustments to the Fixed Rate Component
- Adjustments to the Variable Rate Component
- A calculation of pro forma production cost schedules that are consistent with this docket, including power supply and other adjustments impacting then current production costs.

8 On October 24, 2003, PSE filed with the Commission revisions to its currently effective Tariff WN U-60, designated as Twenty Fifth Revised Sheet No. 95, and Original Sheet Nos. 95-a through 95-e. The stated effective date is November 24, 2003. This filing, which PSE refers to as a PCORC Application,[4] proposes to change PSE's rates recovering the cost of power, in part as a result of its decision to purchase a new generating resource. Specifically, PSE has agreed to purchase a 49.85 percent ownership interest in the Fredrickson I gas-fired generation facility located near Spanaway, Washington. PSE has calculated a new Power Cost Rate that, in the Company's view, accounts for the acquisition, updates expenses to account for current power costs (only some of which are attributable to the acquisition), and corrects the allocation for production related costs.

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[4] PCORC is an acronym for "Power Cost Only Rate Case."

On October 29, 2003, the Commission entered its Complaint And Order Suspending Tariff Revisions; Instituting Investigation; Authorizing Discovery in this proceeding. PSE, as noted in the Commission's suspension order, bears the burden of proof to show that the increases it proposes are fair, just and reasonable. *RCW 80.04.130(2).*

10 The Commission conducted a prehearing conference on November 6, 2003, before Administrative Law Judge Dennis J. Moss. Following discussion, the Commission established procedural schedule that provided for expedited treatment of PSE's filing, consistent with the parties' requests.

11 PSE filed written testimony and exhibits along with its request for rate relief. On January 14, 2004, the Commission entered its Order No. 04 Accepting and Adopting Settlement in Docket No. UE-031389, PSE's first annual true-up of actual power costs under the Power Cost Adjustment Mechanism (PCA) as required by Commission Order in PSE's most recent general rate proceeding.[5] This was a partial settlement, in terms of both parties and issues, but was unopposed by any party. The settling parties were unable to agree in Docket No. UE-031389 on a methodology to determine the costs of power for the Tenaska and Encogen generating resources. The parties agreed that power cost issues related to those resources would be reserved for determination in this proceeding.

12 Commission Staff, Public Counsel, and ICNU filed response testimony and exhibits on January 30, 2004. Only Staff presented testimony concerning PSE's Fredrickson I acquisition. Staff supported the acquisition as prudent and found the associated costs reasonable. All of the response cases included extensive testimony and exhibits concerning the Tenaska and Encogen issues. ICNU, in

[5] *See, supra, fn. 3.*

addition, challenged PSE's estimated fuel gas costs for the PCORC period. PSE filed its rebuttal testimony and exhibits on February 13, 2004. The Commission conducted evidentiary hearings on February 23-26, 2004.

13 The exchange of prefiled testimony and exhibits, coupled with informal discussions among the parties, led to most of the initially disputed issues in this proceeding being resolved by the end of the evidentiary hearings. Staff and PSE filed a formal stipulation with respect to an adjustment proposed via Staff's response testimony by Dr. Yohannes K.G. Mariam, who contested PSE's proposed weather normalization adjustment and proposed an alternative adjustment. The Commission approved the stipulation, by which the parties proposed to accept Dr. Mariam's adjustment, on February 11, 2004.[6]

14 Another Staff witness, Mr. James M. Russell, confirmed by his testimony, and via Exhibit No. 318, that PSE and Staff had reconciled their differences with respect to eleven of the thirteen adjustments Staff had proposed to normalize and pro form various costs included in PSE's original filing. The eleven reconciled issues included three issues also raised by ICNU via Mr. Donald Schoenbeck's prefiled response testimony: Colstrip maintenance outages, March Point generation, and the cost of winter peaking options. Mr. Schoenbeck testified on cross-examination that his client was satisfied with the resolution of these three issues agreed to by PSE and Staff, and would not contest the issues further.

15 There is no dispute among the parties concerning PSE's proposed acquisition of an interest in Fredrickson I. The associated costs that PSE would include in rates for Fredrickson I are disputed only to the extent that base fuel gas costs are at issue. PSE expressly requests our findings and conclusions with respect to

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[6] *WUTC v. PSE*, Order No. 10 Accepting Stipulation Concerning Weather Normalization Issue, Docket No. UE-031725 (February 11, 2004).

Fredrickson I. We discuss below the prudence and reasonableness of PSE's proposed acquisition. In that connection, we discuss and resolve the dispute over whether the Commission should determine, as a matter of policy, that PSE's inclusion of a "regulatory out" provision in its acquisition agreement is contrary to the public interest. This "regulatory out" provision gives either party the right to withdraw from the agreement should PSE fail to obtain Commission approval of the Fredrickson I acquisition by a date certain. Finally, in this Order, we discuss and resolve the disputed issue whether the baseline fuel gas cost PSE proposes for the PCORC period should be adjusted.

16 We expressly reserve for determination in a separate order the one disputed issue in this proceeding that is wholly unrelated to the Fredrickson I acquisition: Should there be an adjustment to the amounts PSE proposes to reflect in rates for power costs the Company incurs in connection with its Tenaska and Encogen assets? Bifurcating our decision process in this fashion clears the way for PSE to move forward with the Fredrickson I acquisition, yet affords the Commission additional time necessary to deliberate fully on the extensive record that was developed with respect to the Tenaska and Encogen issues. We anticipate entering our subsequent order resolving the Tenaska and Encogen issues by April 30, 2004, unless unforeseen circumstances cause delay.

II. Discussion and Decisions

A. Did PSE carry its burden to show that its proposed acquisition of a 49.85 percent interest in Fredrickson I is prudent and that the associated costs are reasonable?

17 In October 2003, PSE agreed to acquire a 49.85 percent ownership interest in the Fredrickson I gas-fired generation facility located near Spanaway, Washington. The acquisition would add between 125 to 137.5 MW of company-owned power to PSE's electric resource portfolio.

18 Although it is not a contested issue in this proceeding, PSE requests the Commission to find and conclude that PSE acted prudently in making the Fredrickson I acquisition. In addition, PSE requests the Commission to find that the decision-making tools and processes PSE employed in deciding to make this acquisition meet the Commission's expectations insofar as prudence review and related regulatory issues are concerned. PSE also requests that we find and conclude that the costs associated with Fredrickson I are reasonable and should be authorized for recovery in rates.

19 The Commission has consistently applied a reasonableness standard when reviewing the prudence of decisions relating to power costs, including those arising from power generation asset acquisitions. The test the Commission applies to measure prudence is what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made a decision.[7] This test applies both to the question of need and the appropriateness of the expenditures.[8] The

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[7] *WUTC v. Puget Sound Power & Light Co.,* Cause No. U-83-54, Fourth Supplemental Order (September 28, 1984) at 32.

[8] *Id.*

company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made.[9]

20 As PSE states in its Initial Brief, the Commission has provided guidance and identified specific factors that should be considered in evaluating the prudence of a utility's decision to acquire a new resource. PSE specifically identifies the following factors:

- The utility must first determine whether new resources are necessary. Once a need has been identified, the utility must determine how to fill that need in a cost-effective manner. When a utility is considering the purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself.

- The utility must analyze the resource alternatives using current information that adjusts for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors need specific analysis at the time of a purchase decision.

- The utility should inform its board of directors about the purchase decision and its costs. The utility should also involve the board in the decision process.

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[9] *WUTC v. Puget Sound Power & Light Co*., Docket No. UE-921262, *et al*., Nineteenth Supplemental Order (September 27, 1994) at 10 (hereinafter "Prudence Order") (*citing WUTC v. Puget Sound Power & Light Co.*, Cause No. U-85-53, Second Supplemental Order (May 16, 1986) and *WUTC v. Washington Water Power Co.*, Cause No. U-83-26, Fifth Supplemental Order (January 19, 1984)). The Prudence Order was introduced as an exhibit in this proceeding. *See, Exhibit No. 82*.

- The utility must keep adequate contemporaneous records that will allow the Commission to evaluate its actions with respect to the decision process. The Commission should be able to follow the utility's decision process; understand the elements that the utility used; and determine the manner in which the utility valued these elements.[10]

21 PSE presented extensive evidence, as discussed at length in its Initial Brief, demonstrating its attention to the prudence standard and the specific factors identified above over a period beginning in October 2001, when the Company formed a load-resource strategies team to assess the Company's load and available resources. By April 2002, the PSE team found that the expiration of certain long-term power supply contracts would result in an expected loss of 688 MW of capacity and 264 aMW of energy from 2002 to 2010.[11] As reflected in PSE's 2003 Least Cost Plan (LCP) and an update to the 2003 LCP, PSE estimated that it would require, by January 2005, approximately 476 aMW of additional energy to meet its load obligations (before conservation). That requirement was projected to increase to approximately 1,715 aMW by January 2013.[12]

22 According to PSE, "Beginning in 2002 and continuing through mid-2003, PSE employed a thorough and systematic process to identify and evaluate different opportunities that could help the Company meet its resource needs."[13] The Company considered conservation, construction of a new generation project, and acquisition of one or more generation projects, execution of one or more purchased power agreements, and some combination of these options. PSE established the goal of acquiring 203 aMW of conservation savings during 2004-

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[10] PSE Initial Brief at 5-6 (citing Prudence Order, *passim*).
[11] *Id.* at 6-7 (citing Exhibit No. 11 at 9:4-10:11 (Gaines); Exhibit No. 14 at 6; Exhibit No. 15 at 10).
[12] *Id.* at 7 (citing Exhibit No. 27 at 2: 12 (Gaines, adopting prefiled direct testimony of Charles J. Black (CJB-1T) at 6: 26 – 7: 21); Exhibit No. 28; Exhibit No. 131 at 7: 1-4 (Markell); Exhibit No. 175; Exhibit No. 176).
[13] *Id.* at 7.

2013, but determined this is not sufficient to meet the Company's expected resource needs. PSE retained a project development/consulting firm in the summer of 2002 to evaluate the self-build option. PSE concluded on the basis of the firm's study that the leading asset acquisition and power purchase options identified by the Company through solicitations to the power industry in September and November 2002, were "equal or superior to the self-build option, and did not carry the completion and other risks that were associated with the self-build alternative."[14]

23 PSE received 58 responses to its September and November solicitations.[15] Mr. Markell discusses in his testimony the Company's evaluation and ranking process.[16] Following due diligence study of the top five gas-fired generation projects, and updated assessment of eleven purchase power options offered by eight companies during the Summer of 2003, PSE management recommended to the Company's Board of Director's to proceed with negotiations to acquire an interest in Fredrickson I. The Board approved the recommendation in October 2003. Subsequently, PSE and the Seller executed a series of transaction documents providing for the purchase, operation and management, shared services, and dispatch of 49.85 percent of the Fredrickson I facility.[17]

24 Among numerous other provisions, the Purchase and Sale Agreement includes a "regulatory out" clause that gives either PSE or the Seller the right to terminate the Agreement if, within a specified time, PSE does not receive Commission

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[14] *Id.* at 9 (citing Exhibit No. 131 at 32:13-25 (Markell); Exhibit No. 133HC at 80).
[15] *Id.* at 10.
[16] Exhibit No. 131 at 19: 9 – 24: 22, 25: 22 – 28: 20 (Markell). *See also* Exhibit No. 143HC; Exhibit No. 148HC at 5-7, 10; Exhibit No. 150HC; Exhibit No. 153HC; Exhibit No. 154HC at 4-8.
[17] PSE Initial Brief at 11 (citing Exhibit No. 167HC; Exhibit No. 168HC; Exhibit No. 169HC; Exhibit No. 170HC).

approval to include its acquisition costs in rates.[18] We return to discuss the dispute over this provision in section II.B., below. For present purposes we note that the inclusion of this provision, among other things, led to PSE's filing that initiated this proceeding.

25 Mr. Hank McIntosh, a Regulatory Analyst at the Commission, testified for Staff that he reviewed the Company's testimony and exhibits pertaining to the Fredrickson I acquisition as sponsored by Mr. Markell, Mr. Gaines, Mr. Black (later adopted by Messrs. Gaines, Granowski, and Markell), and Ms. Ryan.[19] Mr. McIntosh also participated in the discovery process and examined PSE's responses to data requests concerning the acquisition. Mr. McIntosh examined the Company's Portfolio Analysis Modeling tool, which he found to have been central to PSE's analysis. According to PSE, Mr. McIntosh also interviewed PSE staff and consulting personnel who worked on the acquisition.[20]

26 Mr. McIntosh found PSE's decision to be prudent, meaning, in his words, "the decision . . . was based upon appropriate, rational and reasoned methods, utilized appropriate data, and covered specific issues which the Commission listed in the 19th Supplemental Order in Docket No. UE-921262, the 'Prudence Review.'"[21] Mr. McIntosh testified that he relied on the Commission's Prudence Order,[22] in evaluating PSE's decision to acquire an interest in Fredrickson I. Mr. McIntosh testified that PSE's analysis of Fredrickson I included appropriate consideration of the factors enumerated by the Commission in the Prudence Order.[23] Finally, Mr. McIntosh found that PSE had appropriately considered risk

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[18] *Id. at 13.* The regulatory out clause is Article 14.1(a)(ix) in the Agreement (Exhibit No. 167HC at 80-81). The specific regulatory approval required from the Commission is found in Schedule 1.1(d) (Exhibit No. 167hC at 92).
[19] Exhibit No. 291HC at 3 (McIntosh).
[20] PSE Initial Brief at 11.
[21] Exhibit No. 291HC at 4 (McIntosh).
[22] *Supra*, fn. 10.
[23] Exhibit No. 291HC at 5-6 (McIntosh).

in its evaluation process, including gas fuel market and electric market price risk, and the effect of hydrological conditions modeled by using market demand under average 40-year hydro conditions.[24]

27 Mr. McIntosh summarized his conclusion that PSE's acquisition of Fredrickson I was a prudent decision as follows:

> The Company had a clear documented need for power in the near term. It also had a deliberate, organized process for soliciting and evaluating bids. It examined a self-build option. It examined contract purchases and ownership of new resources. It kept detailed records of crafting the evaluation method, data acquisition, and resource evaluation. The evaluation process was largely a matter of modeling that can be replicated.[25]

28 Mr. McIntosh also reviewed PSE's costs in the Fredrickson I acquisition and PSE's comparison of Fredrickson I to other resources. He compared Fredrickson's average cost per kW to averages currently available to him from other sources. He concluded that Fredrickson's price level is reasonable.[26] Mr. McIntosh testified in this connection that he did not review future fuel gas costs because there is no specific supply contract in place. He stated that the public interest is protected in this regard by the Commission's authority to review prudence in future proceedings, including general rate cases, PCAs, or PCORCs.[27] We consider PSE's fuel gas costs for the PCORC rate period, including projected fuel gas costs for Fredrickson I, in section II.C. of this Order.

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[24] *Id.* at 7.

[25] *Id.*

[26] *Id.* at 8.

[27] *Id.* at 9.

29 Our extended discussion of this undisputed matter establishes the underlying bases for our ultimate finding and conclusion that PSE acted prudently in making the Fredrickson I acquisition. PSE employed decision-making tools and processes that meet our expectations. PSE thoroughly and appropriately documented its decision-making, consistent with our prior orders that discuss the importance of detailed record keeping in connection with management decisions that are subject to prudence review. The Commission commends PSE for presenting a well-documented case on the prudence of the Fredrickson I acquisition and the reasonableness of its costs. We also commend Staff for its thorough review, concisely presented through its witness's testimony. It is a testament to these parties' efforts that the Commission was able to process and consider this aspect of the proceeding on a highly expedited basis, as requested by the Company. [28]

30 We turn next to our discussion and determination of two contested issues in this proceeding that relate to Fredrickson I. The first of these arises from a policy concern with respect to a particular clause included in the Fredrickson I Purchase and Sale Agreement. The second implicates the costs PSE seeks to include in rates in connection with the acquisition.

[28] Given the parties' efforts and considering all relevant facts and circumstances, it was possible in this instance to evaluate the prudence of PSE's decision-making, and to consider the reasonableness of the costs incurred, in the context of the PCORC mechanism (*i.e.,* a "single issue" rate proceeding). We expect that the PCORC will continue to be a useful tool; suitable in some instances to evaluate prudence and reasonableness as PSE takes additional steps to meet its power supply needs. In other instances, it may be necessary to consider these questions in the broader setting of a general rate proceeding.

B. Should the Commission determine, as a matter of policy, that PSE's inclusion of a "regulatory out" provision in its agreement to purchase the Fredrickson I asset, whereby PSE's failure to obtain Commission approval of the acquisition by a date certain would give either party the right to withdraw from the agreement, is a provision that is contrary to the public interest?

1. Staff's Challenge

31 As previously discussed, PSE's Purchase and Sale Agreement for Fredrickson I includes a "regulatory out" clause.[29] The provision gives both PSE and the seller the right to terminate the Agreement if, within a specified time, PSE does not receive Commission approval to include the costs of the acquisition in rates. The provision is not self-executing, but may be invoked by either party to the Agreement.

32 Staff asks the Commission to find that the regulatory-out clause "is contrary to the public interest and existing sound regulatory policy."[30] Staff argues that the clause "improperly shifts the responsibility for" PSE to meet its load with a least-cost mix of generating resources and conservation from the Company to the Commission.[31] This argument is based on the idea that the clause "requires the Commission to first provide rate recovery before the Company will consummate a transaction to acquire a resource."[32] Staff describes this as "pre-approval" and states that it is contrary to "sound Commission practice and policy that has been in effect since the mid-1980's."[33]

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[29] *Supra,* ¶¶ 15 and 24.
[30] Staff Initial Brief at 48, ¶108.
[31] *Id.* at 48-49, ¶109.
[32] *Id.*
[33] *Id.*

33 Staff argues that the disputed clause is not consistent with the PCORC process that was established in Docket No. UE-011570. Staff argues that the clause "[eases] the Company's burden to prove that it has prudently acquired resources at reasonable cost."[34] Staff states the PCORC process was not "intended to eliminate or alter the prudence review of new resource decisions by the Company."[35]

34 Staff argues that because inclusion of a regulatory-out provision was part of PSE's solicitation process, some developers might not have responded, thus restricting the "universe of project developers." Finally, Staff argues that including a regulatory-out clause may have affected the timing and price of the resource acquisition to the detriment of customers.

2. PSE's Response

35 PSE argues in its initial brief that the clause is typical of risk-reduction clauses "commonly included in resource acquisition agreements" and that such clauses are an appropriate means "to eliminate or reduce the impact of regulatory risk."[36] PSE argues that the financial markets respond favorably to such risk reduction, which can result in lower financing costs.

36 PSE asserts that, "the PSA clause was appropriate due to the nature of the Frederickson 1 acquisition and this proceeding."[37] This argument is predicated on PSE's perspective that the Fredrickson I acquisition, and the Commission's assessment of that acquisition will "lay the foundation for regulatory oversight of

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[34] *Id.* at 49, ¶110.
[35] *Id.* at 49, ¶111.

[36] PSE Initial Brief at 13.
[37] *Id.* at 14.

future transactions."[38] Thus, PSE sought expedited review under the PCORC process. As Mr. Markell testified, this will help the Company determine whether PSE's "processes, . . . analyses [and] the way we went about our decision making with respect to this specific transaction met the burdens of proof set forth in the Commission's standards for prudent management practice."[39] PSE argues, "In sum, the [regulatory out] clause added a vital component to the Fredrickson transaction."[40]

37 Anticipating Staff's argument that including a regulatory-out clause may have affected the price PSE paid for Fredrickson I, PSE contends that "the clause led to a price reduction."[41] It appears from Mr. Markell's testimony that the Company's insistence on a regulatory out clause did not result in a price increase in this instance.[42]

38 PSE's reply brief does not address Staff's other arguments as presented in Staff's Initial Brief. Thus, we are left to evaluate the significance of Staff's first four points on our own.

3. Commission Analysis and Decision

39 Staff does not explain the rationale underlying its first argument. We are left to ponder what exact "policy and practice" Staff means, what circumstances led to such policy and practice in the first place, why such policy and practice has

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[38] *Id.*

[39] TR. 110:13-17. *See also* TR. 104: 14 – 105: 3 (Markell) (the Commission's approval would affirm that "our procedures and analysis and data and our communications with the board were adequate and met those [prudence] standards," and that "we have met the burdens set forth in those general standards").

[40] PSE Initial Brief at 15.

[41] *Id.* at 14 (citing Exhibit No. 182 at 9:9-23 (Markell); *see also* Exhibit No. 184HC).

[42] TR. 112:22-116:12.

remained in effect, and why it should continue to be applied in present circumstances. We are mindful in this context that one of the central purposes of the PCORC, as Staff acknowledges, was to "expedite ratemaking so that the Company could have rates sufficient to recover the cost of a new resource when that resource went 'on-line.'" Although the PCORC process may not be adequate or appropriate to the Commission's consideration of all resource acquisitions by PSE, we do find it appropriate in this instance.

40 Staff does not explain how the presence of this clause has affected the Company's burden of proof obligations. Whenever the Commission examines the acquisition of an asset the Company's burden to document the prudence of its decision-making and the reasonableness of the costs incurred is the same. It appears to us that the only sense in which PSE's burden of proof has been "eased" is that showing prudent behavior on a contemporaneous basis is certainly an easier undertaking than trying to carry that burden years after the decisions were made. We note, too, that a more or less contemporaneous prudence review is easier for Staff and others, and for the Commission. In this sense, then, it is materially better to review prudence closer in time to when the decisions are made than to wait until some future date when it is more challenging to apply the reasonableness standard. Admittedly, PSE could have sought prompt prudence review without inclusion of the clause. But, given PSE's intention to seek a contemporaneous review, it makes sense to allow the transaction to be cancelled if the Commission finds it imprudent.

41 Staff's third and fourth points may have merit in the abstract, but are speculative in the context of the present case. It is possible that a regulatory-out clause affected the solicitation process and bid prices for new resources, or might have such an effect in some future solicitation. However, there simply is no evidence in our record that shows such an effect in this instance. We note, too, that while some potential bidders might elect not to bid, given the requirement for a

regulatory-out clause, others might be encouraged to bid on the basis that such a clause would be considered positively in the financial markets.

42 Similarly, while it may be that PSE could have obtained benefit from the acquisition at an earlier time had it not included the regulatory out clause, our record does not support a finding on this question. It is also arguable in the abstract that reducing regulatory uncertainty for all parties to a transaction may accelerate an acquisition process.

43 We caution PSE that the Company should consider carefully in future solicitations the potential effects that insistence on a regulatory out clause might have in the market. PSE may be required in a future proceeding to show that requiring such a provision in a resource acquisition agreement is appropriate under the relevant facts and circumstances that exist at the time a solicitation process is undertaken.

44 With respect to Staff's final argument, it appears that the regulatory out clause did not have an adverse affect on price in this instance. Again, however, that might not always be the case. One can to conceive of fact-specific circumstances under which insistence on the inclusion of such a provision could come at a price. If that occurs in a future acquisition, PSE will bear the burden to show the reasonableness of the costs incurred.

45 To conclude, at least based on the facts of this case, we reject Staff's argument that we should determine that, in all instances, the regulatory out clause "is contrary to the public interest and existing sound regulatory policy."[43]

[43] Staff Initial Brief at 48.

C. Should the baseline fuel gas cost PSE proposes for the PCORC period be adjusted?

1. ICNU Challenge

46 PSE used forward market prices to project natural gas prices for the 2004 PCORC Baseline Rate in this proceeding. Specifically, PSE used an average of forward market prices that was published over a 10-day consecutive period ending September 18, 2003. According to Mr. Gaines, the Company selected the September period because it wanted to file prices that were the most indicative of the then-current forward market.[44]

47 ICNU argues that the September 2003 NYMEX prices are inappropriate for establishing a "normalized" power cost baseline because the NYMEX market for the Rate Period was not liquid in September 2003, and NYMEX prices reflect the impact of near-term events.[45] ICNU argues that PSE's baseline gas prices should be based on a market fundamentals analysis. ICNU specifically recommends use of a recent California Energy Commission (CEC) North American Regional Gas (NARG) forecast, as discussed by Mr. Schoenbeck in his testimony. ICNU recommends alternatively that the Commission require PSE to use the median gas forecast developed by the Company's own fundamentals model.

48 ICNU states "PSE's fundamentals analysis is a much more rigorous analysis than an average of NYMEX prices and generally produces more realistic results, because it reflects market fundamentals."[46] ICNU argues that the results of PSE's fundamentals analysis presented to the Company's Risk Management Committee (RMC) in December 2001 is validated by the similar values Mr.

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[44] Exhibit No. 45 at 30: 26 – 31: 3 (Gaines).
[45] ICNU Initial Brief at 2, 6.
[46] *Id.* at 10.

Schoenbeck derived from the CEC NARG forecast. According to ICNU, "PSE should not be permitted to use one set of gas prices for its risk analysis and internal decision making, but use different, substantially higher prices for ratemaking purposes."[47]

49 Citing certain data that remain part of the confidential record, ICNU shows that PSE's fundamentals analysis from December 2003 produced a median price that is about 16 percent lower than the price PSE proposes to include for the PCORC rate period.[48] ICNU attributes this difference to the effect of short-term events that it argues may inflate a projected price based on NYMEX data.[49] ICNU argues that fluctuation in NYMEX average prices due to short-term events means such prices do not represent a normalized price over the long term, which should be used for setting the PCA Baseline.[50]

50 ICNU argues that the second "fundamental problem" with PSE's use of a NYMEX average is that the "volume of transactions during the ten-day period in September 2003 for power delivery during the [PCORC] Rate Period was not significant enough to constitute a liquid market."[51] Such a market, ICNU argues, does not yield an accurate depiction of market prices. ICNU states that only seven percent of the transactions on which PSE relies were for delivery in the first three months of the Rate Period, and only one percent was for delivery in the last nine months of the Rate Period.[52] ICNU concludes, "A market with such a relatively small volume of transactions for delivery in the Rate Period is not meaningful or robust enough to obtain a realistic forecast of gas prices for the Rate Period.

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[47] *Id.* at 11.
[48] *Id.* at 12 (citing Exhibit No. 231C at 12:20, 16:17-19 (Schoenbeck)).
[49] *Id.* at 13 (citing TR. 376:12-14 (Schoenbeck)).
[50] *Id.* at 14.
[51] *Id.* at 17.
[52] *Id.* (citing Exhibit No. 235C).

2. PSE Response

51 PSE argues that it used NYMEX forward prices in this proceeding, as it has in other proceedings,[53] because they are objective, reliable, and inherently unbiased, based as they are on market transactions by multiple entities that enter agreements to buy and sell energy for future delivery.[54] PSE states in another context that "years of Commission precedent . . . support the use of market-based pricing data to estimate gas costs."[55] PSE, however, cites to no line of Commission decisions that support this assertion.

52 PSE argues that the PCA mechanism should reflect "expected costs" during the rate year, not long-term normalized costs as ICNU advocates.[56] PSE states that the goal should be to estimate PSE's future gas costs "as accurately as possible, so that an equal chance of over- and under-recovery will exist."[57] ICNU's approach, according to PSE, "is inconsistent with the PCA Mechanism's basic objective" and unbalances the mechanism by setting a gas price that ICNU's witness acknowledges is unlikely to reflect PSE's actual gas costs during the near term.[58]

53 PSE argues that ICNU has failed to establish a foundation for the use of the CEC model as a ratemaking tool and that such use would be unprecedented.[59] PSE states that there is no evidence to show that differences between the NYMEX

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[53] PSE states that it used the same methodology in its 2001 general rate case filing (*i.e.,* consolidated Docket Nos. UE-011570 and UG-011571) and in settling that proceeding, which established the PCA mechanism. PSE also uses this method in its PGA filings.
[54] PSE Initial Brief at 43.
[55] *Id.* at 47.
[56] *Id*. at 44.
[57] *Id.* at 45 (citing Exhibit No. 220 at 5:22-24 (Story)); See also Exhibit No. 45 at 32:18-22 (Gaines) and TR. 579:19 – 581:25 (Lott).
[58] *Id.* (citing TR. 435:25 – 436:7 (Schoenbeck); TR. 582:21 – 584:10 (Lott).
[59] *Id.* at 46-47.

forward prices and CEC model results are, in fact, attributable to short-term market impacts, even if such impacts should be ignored in setting the baseline. In general, PSE argues that our record is inadequate to support use of the CEC approach advocated by ICNU.[60]

3. Staff's Perspective

54 Staff does not challenge PSE's use of NYMEX prices, finding that approach adequate for purposes of this proceeding.[61] Staff recommends that in a future general rate proceeding, or in another PCORC, this issue should be revisited because the issue will be more important as PSE adds to its supply portfolio additional natural gas turbines, such as Fredrickson I.

4. Commission Analysis and Decision

55 ICNU has raised important questions concerning how a baseline fuel gas price should be established for ratemaking in the context of a PCORC proceeding, and otherwise. We find, however, that the record in this proceeding is not adequately developed to support our adoption of either of the alternatives ICNU recommends. While there is no Commission policy that requires, or even endorses, the use of NYMEX forward prices, the Commission previously has approved rates based in part on such data for purposes of establishing both electric rates and natural gas rates. We find PSE's approach adequately supported for purposes of this proceeding.

56 We agree with Staff that this is an issue that will grow in importance and one that requires additional scrutiny. PSE, too, states on brief that it is "amenable to

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[60] PSE Reply Brief at 31.
[61] Staff Initial Brief at 46.

a different measurement or averaging period and future discussions concerning other regulatory mechanisms that eliminate the possibility of cost over- or under-recovery."[62] These questions should be revisited in a future proceeding. PSE's recently filed general rate case will provide an opportunity for parties to develop this issue more fully.

FINDINGS OF FACT

57 Having discussed above all matters material to our decision, and having stated general findings, the Commission now makes the following summary findings of fact. Those portions of the preceding discussion that include findings pertaining to the Commission's ultimate decisions are incorporated by this reference.

58 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including electric companies.

59 (2) Puget Sound Energy, Inc. (PSE), is a "public service company" and an "electrical company" as those terms are defined in RCW 80.04.010, and as those terms otherwise may be used in Title 80 RCW. PSE is engaged in Washington State in the business of supplying utility services and commodities to the public for compensation.

60 (3) On October 24, 2003, PSE filed with the Commission revisions to its currently effective Tariff WN U-60, designated as Twenty Fifth Revised Sheet No. 95, and Original Sheet Nos. 95-a through 95-e. This filing is a proposal to change PSE's rates recovering the cost of power, as a result of its decision to purchase a new generating resource, and for other reasons.

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[62] PSE Initial Brief at 49.

61 (4) The rates proposed by tariff revisions filed by PSE on October 24, 2003, and suspended by prior Commission order, are not just, fair, or reasonable.

62 (5) PSE has carried its burden to show that its acquisition of a 49.85 percent interest in the Fredrickson I generating facility is prudent.

63 (6) PSE has carried its burden to show that the costs the Company proposes to include in rates for the PCORC rate period, as modified during the course of this proceeding and reflected in Exhibit No. 318, line 5, are reasonable.

64 (7) PSE's use of NYMEX-based prices to establish a fuel gas cost price for the PCORC rate period is adequately supported by the record in this proceeding; proposed alternatives to this method are not adequately supported by the record; alternative approaches are appropriate for consideration in future proceedings.

CONCLUSIONS OF LAW

65 Having discussed above in detail all matters material to our decision, and having stated general findings and conclusions, the Commission now makes the following summary conclusions of law. Those portions of the preceding detailed discussion that state conclusions pertaining to the Commission's ultimate decisions are incorporated by this reference.

66 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to, these proceedings. *Title 80 RCW.*

67 (2) PSE's costs associated with its acquisition of Fredrickson I, as reflected in Exhibit No. 318, line 5, should be approved for recovery in permanent rates at the time PSE consummates the acquisition and places the plant in service.

68 (3) Including PSE's costs associated with its acquisition of Fredrickson I, as reflected in Exhibit No. 318, line 5, in PSE permanent rates at the time PSE places the plant in service will result in rates, terms, and conditions of service that are fair, just, reasonable, and sufficient. *RCW 80.28.010; RCW 80.28.020.*

69 (4) Including PSE's costs associated with its acquisition of Fredrickson I, as reflected in Exhibit No. 318, line 5, in PSE permanent rates at the time PSE places the plant in service will result in rates, terms, and conditions of service that are neither unduly preferential nor discriminatory. *RCW 80.28.020.*

70 (5) PSE's use of NYMEX-based prices to establish a fuel gas cost price for the PCORC rate period should be approved for purposes of this proceeding, subject to the condition that the issue of the appropriate basis for determining fuel gas costs will be considered in the Company's next general rate proceeding; PSE should bear the burden of proof in any such proceeding regarding this issue.

71 (6) The Commission Secretary should be authorized to accept by letter, with copies to all parties to this proceeding, such filings as PSE may make to comply with the requirements of this Order. *WAC 480-09-340.*

72 (7) The Commission should retain jurisdiction to effectuate the terms of this Order. *Title 80* RCW.

ORDER

THE COMMISSION ORDERS THAT:

73 (1) PSE is authorized to file revised tariff sheets reflecting its costs associated with the acquisition of Fredrickson I, as reflected in Exhibit No. 318, line 5 at such time as PSE places the plant in service.

74 (2) PSE's use of NYMEX-based prices to establish a fuel gas cost price for the PCORC rate period is approved for purposes of this proceeding, subject to the condition that the issue of the appropriate basis for determining fuel gas costs will be considered in the Company's next general rate proceeding; PSE bears the burden of proof in any such proceeding regarding this issue.

75 (3) The Commission Secretary is authorized to accept by letter, with copies to all parties to this proceeding, such filings as PSE may make to comply with the terms of this Order.

76 (4) The Commission retains jurisdiction over the subject matter and the parties to effectuate the terms of this Order.

DATED at Olympia, Washington, and effective this 7th day of April 2004.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARILYN SHOWALTER, Chairwoman

RICHARD HEMSTAD, Commissioner

PATRICK J. OSHIE, Commissioner

NOTICE TO PARTIES: This is a final order of the Commission with respect to certain issues resolved. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 and WAC 480-07-870.