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 PETITION FOR RECONSIDERATION AND CLARIFICATION OF ORDER NO. 14

Pursuant to WAC 480-07-850, Puget Sound Energy, Inc. ("PSE") requests that the Commission reconsider its Order No. 14 in this proceeding, entered on May 13, 2004 ("Tenaska Order"). Reconsideration is necessary because the Commission erred when it applied an unlawful and unwise variant of the "used and useful" standard to analyze and disallow certain of PSE's Tenaska-related costs.

PSE further requests, pursuant to WAC 480-07-835, that the Commission clarify certain aspects of the Tenaska Order. Clarification is necessary because the Tenaska Order does not address or explain certain issues sufficiently to authorize the necessary accounting treatment or permit PSE to comply with the Commission's directives in its PCA mechanism accounting and in future PCA compliance filings.

I. INTRODUCTION.

The multi-million dollar disallowances that the Tenaska Order imposes[1] unfairly punish PSE for its fuel management decisions related to the Tenaska resource. PSE continues to believe that these decisions were reasonable when made, given the information that PSE possessed and reasonably could have known at the time of the decisions.

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[1] *See* Tenaska Order at ¶¶ 93, 97 ($25.6 million disallowance for the PCA period and $9.9 million projected under-recovery for the PCORC rate year).

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PSE's concern with the Tenaska Order, however, goes beyond the disallowance amounts. The Commission has adopted and applied a new regulatory test in the Tenaska Order. Described as a "used and useful" theory,[2] the new test instead evaluates a resource by narrowly assessing its economic value at indeterminate review points rather than according to the resource's physical use and availability for service. Such an economic test – which has been characterized as "heavily skewed towards ratepayers"[3] – significantly distorts the used and useful standard that has been traditionally applied in Washington State.[4] Under the new test, it is no longer sufficient for an asset to be prudently acquired and physically used to serve load. PSE must also show that the asset produces net economic "benefits" during every period of the asset's life before PSE can recover the related costs in rates.

PSE believes that this economic net benefits test is unlawful, inequitable, and represents bad public policy for this state. The new test eclipses the long-standing prudence standard upon which PSE and other utilities have always relied and assumed that they would be judged. In addition, the new test compromises the Commission's least cost planning standard, increases uncertainty for the electric industry, increases costs for utilities and their customers, and imposes asymmetric risks that are inequitable. For these reasons, PSE respectfully requests that the Commission reconsider the Tenaska Order and strike its references to, and reliance upon, the new economic test. The Commission should recalculate any disallowances for the Tenaska asset based solely upon the prudence standard.

If the Commission does not reconsider the Tenaska Order, then it should clarify how the significant disallowances should be implemented. The accounting and ratemaking treatment of the disallowances are complicated by the PCA cost allocation mechanism. While the Commission appears to have intended a $25.6 million, "one-time" disallowance to be applied with respect to the 12-month PCA period that ended June 30, 2003 ("PCA Period 1"),

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[2] *See Id.* at ¶¶ 78, 85.

[3] *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1191 (D.C. Cir. 1987) (hereinafter "*Jersey Central*") (Starr, Circuit Judge, concurring).

[4] *See* RCW 80.04.250 (used and useful concept as applicable to rate regulation in Washington State); *see also* the discussion in Sections II(A)(1) and II(B)(1) of this Petition.

the actual impact resulting from the Tenaska Order could be more than $42 million through December 2004 under application of the Tenaska Order as currently written and applied to the PCA mechanism. Consequently, PSE asks the Commission to clarify how the disallowances should be implemented today; how the disallowances will affect the 12-month PCA period ending June 30, 2004 ("PCA Period 2"); and what the Tenaska Order's disallowances mean for future rate periods.[5]

II. THE COMMISSION SHOULD RECONSIDER THE TENASKA ORDER AND STRIKE ITS NEW ECONOMIC TEST.

A. The Commission Has Adopted A New Regulatory Standard With No Support Under Washington Law.

The Tenaska Order frames the key issue: "[S]hould there be an adjustment to the amounts PSE proposes to recover for power costs incurred in connection with its Tenaska and Encogen assets?"[6] This issue could and should have been resolved by applying the Commission's well-established prudence standard, which the Commission recites in the Tenaska Order.[7] PSE and the other parties presented numerous witnesses, extensive evidence, and substantial briefing concerning this standard and its relation to Tenaska power costs. No party argued that a review standard other than prudence should apply.[8]

Yet, while the Commission begins its inquiry in the Tenaska Order by discussing prudence, it resolves the power cost issue on entirely different grounds, through a "hybrid" approach that attempts to meld the prudence standard with an entirely new regulatory standard – an economic variant of the traditional and accepted used and useful standard. The Commission adopted and applied this new test without receiving any evidence or briefing concerning the appropriateness of the new test. The Commission should strike the Tenaska

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5 PSE also asks the Commission to confirm and authorize various accounting details regarding the Tenaska Order that are not contested by any party, but are not explicitly set forth in the Tenaska Order. *See* the discussion in Section III(A) of this Petition.

6 Tenaska Order at ¶ 10.

7 *Id.* at ¶ 65.

8 *Id.* at ¶ 78 ("[the parties] do not expressly argue for the direct application of the used and useful theory of rate regulation").

Order's references to, and reliance upon, such a new test because it is not supported by Washington law.

1. The Tenaska Order Makes The Traditional Used And Useful Standard Into An Economic Test, Which Is Inappropriate In Washington State.

The Tenaska Order couches the used and useful standard not in its traditional and accepted form, but in the context of an asset's economic "value" measured at indeterminate, and isolated, review points – in "given rate period[s]" according to the Tenaska Order.[9] This economic "value" is assessed narrowly through a singular comparison of a resource's costs to a "benchmark" – the costs of a hypothetical alternative. If an asset does not provide economic "benefits" during a particular review period that are commensurate with the asset's costs in rates for that period, then "the corresponding costs should be disallowed going forward because the asset is not useful."[10] Such a test – which looks exclusively and restrictively at an asset's economic net benefits at various and indeterminate review points – represents a distortion of the used and useful standard that is inappropriate for use in Washington State.

The traditional used and useful standard is an established method of rate regulation. Under the standard, a utility's investment that is deemed *not* used and useful could be denied rate recovery. The regulator determines whether a resource is in-service and provides actual physical services that are relevant for customers who are asked, in rates, to pay for those services. The distinction between "used" and "useful," then, is between "investments that do not provide physical services (not used) and those that, while providing physical services, are superfluous (not useful)."[11]

This definition of used and useful – premised on an asset's physical use and availability for service – has been consistently followed in Washington State. The

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[9] *Id.*

[10] *Id.*

[11] Lesser, *The Used and Useful Test: Implications for a Restructured Electric Industry*, 23 Energy Law Journal 349, 352 (2002) (hereinafter "Lesser"); *see also* Goodman, *The Process of Ratemaking*, Vol. 2 (Public Utilities Reports 1998) (hereinafter "Goodman") at 799 (used and useful principle characterized as whether "the properties in issue will be in service in the test year or near-term future period").

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Commission may, under RCW 80.04.250, determine the fair value for rate making purposes of utility property deemed "used and useful for service." The Washington Supreme Court reviewed the statutory phrase in its *POWER 1* decision[12] and determined that "used" in RCW 80.04.250 means "employed in accomplishing something," whereas "useful" means "capable of being put to use; having utility; advantageous; producing or having the power to produce good; serviceable for a beneficial end or object."[13] According to the court, "RCW 80.04.250 empowers the Commission to determine, for ratemaking purposes, the fair value of property which is employed for service in Washington *and* capable of being put to use for service in Washington."[14]

In the Tenaska Order, however, the Commission fundamentally changes the used and useful standard despite not having received any evidence or briefing to support the change. As adopted and applied in the Tenaska Order, the standard involves not a physical test, but an economic test. Under the Tenaska Order, it is not sufficient for ratemaking purposes to show that an asset has been or is physically employed for service and capable of being put to use. PSE must also show that the asset produces net economic "benefits" (as measured against a "benchmark") at *every step of the asset's life* even if the original investment decision and management of the asset were prudent. If the investment should fail this economic test during any particular review period, then PSE faces a significant cost disallowance.

The Tenaska Order's distortion of the traditional used and useful standard – to encompass an economic test – represents not only bad public policy,[15] but a test that is inconsistent with established law in this state. The Commission has rejected the use and application of the economic used and useful test on at least one occasion.[16] Further, RCW 80.04.250 empowers the Commission to employ a *physical* used and useful test for ratemaking

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[12] *People's Organization for Washington Energy Resources v. Washington Utilities and Transportation Commission*, 101 Wn.2d 425, 679 P.2d 922 (Wash. 1984).
[13] *Id.* at 430 (citation omitted).
[14] *Id.* (emphasis original).
[15] *See* the discussion in Section II(B) of this Petition.
[16] *See WUTC v. Washington Water Power Co.*, Third Supplemental Order, Cause No. U-85-36 (April 4, 1986) (hereinafter "*Water Power*") at 13.

purposes -- not an *economic* used and useful test. For this reason, the Commission exceeds its authority when it employs such an economic test in the Tenaska Order. While the Commission has broad powers under RCW 80.28.010, it cannot use those broad powers to contradict or rewrite another, more specific statute (RCW 80.04.250).

2. The Use Of The New Economic Test To Limit Tenaska Cost Recovery Is Inconsistent With Washington Law.

Under the Tenaska Order's "rules of recovery" (which are founded upon the new economic net benefits test), if PSE's fuel purchases are deemed prudent, then it will receive its full return on the Tenaska asset if, but only if, the "net Tenaska costs" (which include operating expenses such as fuel costs) fall below the 1992 cost "benchmark" that the Tenaska Order establishes.[17] Under Washington law, however, the Commission cannot use the new economic test in this fashion to limit recovery of PSE's Tenaska-related costs.

PSE discussed above how, consistent with traditional ratemaking theory and the *POWER 1* decision, the used and useful standard in RCW 80.04.250 provides for a physical test rather than an economic test. But regardless of whether the statutory language means "physically" used and useful or "economically" used and useful, the concept applies for ratemaking purposes *only* to valuation of a utility's rate base. The concept does not apply to a utility's operating expenses.

This conclusion is borne out by the *POWER 2* decision,[18] in which the Washington Supreme Court concluded that the used and useful standard in RCW 80.04.250 does not apply to a utility's operating expenses since "[the statute] is purely a rate base statute."[19] The Commission reached a similar result in a 1984 proceeding: "[T]he argument that the used and useful concept found in RCW 80.04.250 applies to operating expenses is erroneous as a matter of law."[20] The Commission concluded in the same proceeding that *prudence*, rather than

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[17] Tenaska Order at ¶ 95.

[18] *People's Organization for Washington Energy Resources v. Washington Utilities and Transportation Commission*, 104 Wn.2d 798, 711 P.2d 319 (Wash. 1985).

[19] *Id.* at 815.

[20] *WUTC v. Puget Sound Power and Light Company*, Cause U-83-54, Fourth Supplemental Order (September 28, 1984) at 30.

usefulness, is the proper approach to follow when evaluating whether a particular operating expense should be recovered in rates.[21]

In the Tenaska Order, however, the Commission applies the used and useful standard far beyond the bounds of statute and precedent. Contrary to its 1984 decision, the Commission does not rely on prudence as the standard for determining Tenaska cost recovery. Instead, the Commission applies a new economic test to deny PSE full recovery of its Tenaska costs for the PCORC rate year and, potentially, for later review periods (should costs in those periods exceed the 1992 cost level). Under the Tenaska Order, operating expenses such as fuel costs are combined with other costs, then compared to the 1992 cost benchmark, in order to decide whether to allow full recovery of the return on the asset.

The application of the new economic net benefits test in this manner violates the letter and spirit of RCW 80.04.250, the *POWER 2* decision, and the Commission's 1984 decision. The new test uses operating expenses such a fuel costs as an essential cost "driver" to determine whether the return on the Tenaska asset is fully recoverable. The operating expenses are thus inexorably tied, under the new test, to the costs (*i.e.*, the return on the asset) that are potentially disallowable under the Tenaska Order. Thus, while the Tenaska Order nominally entitles PSE to recover its fuel costs,[22] the Order's practical effect is to make those costs a linchpin in determining potential disallowances under the Commission's recovery rule. The use of fuel costs in this manner – to functionally determine recovery on funds invested in an asset under a so-called used and useful test – is an inappropriate application of the used and useful standard under Washington law.

3. The Retroactive Application Of The New Economic Test, According To A Cost "Benchmark," Violates Fundamental Notions Of Fairness, Due Process, And Ratemaking Principles.

At no time has PSE ever understood that its management of the Tenaska asset could or would be judged by the new economic test set forth in the Tenaska Order. The Commission's

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[21] *Id.*

[22] Tenaska Order at ¶ 95.

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retroactive application of this test – to arrive at both a $25.6 million "one-time" disallowance for the PCA 1 Period,[23] a $9.9 million under-recovery for the PCORC rate year,[24] and additional disallowances as discussed below – violates fundamental notions of fairness, due process, and ratemaking principles.

The Commission has addressed the Tenaska resource many times before, beginning in the early 1990s with the proceedings that led to the Commission's Prudence Order.[25] The Commission did not frame its discussion in those proceedings as a function of the Tenaska resource's future economic benefits. Nor did the Commission put PSE on notice that future cost recovery would be determined using an economic test that "looks back" to the 1992 Tenaska contract costs. Instead, the Commission affirmed its oft-stated prudence standard as the test by which PSE's decisionmaking would be reviewed.[26]

The Commission's use of, and reliance upon, the prudence test – and only that test – to evaluate the Tenaska resource did not change when it approved the creation of the regulatory asset in 1997. The Order in Docket No. UE-971619 stated unequivocally that the 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."*[27] PSE was thus put on notice that the Commission would evaluate its management of the Tenaska asset according to the prudence standard – *not* a "hybrid" standard that includes an economic component. The Commission notes in the Tenaska Order that an economic test for cost review and recovery "was not expressly articulated when the regulatory asset was created."[28]

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[23] *Id.* at ¶ 93.
[24] *Id.* at ¶ 95.
[25] *WUTC v. Puget Sound Power & Light Co*., Docket No. UE-921262, *et al*., Nineteenth Supplemental Order (September 27, 1994).
[26] Goodman quotes the Prudence Order's standard as the sole test by which the Commission evaluates utility resource decisions in Washington State, including power purchase contracts, successfully completed projects, and abandoned projects. *See* Goodman at 881-882.
[27] Exh. No. 283C at 24 ¶ 6 (*citing* the Prudence Order) (emphasis added).
[28] Tenaska Order at ¶ 78.

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Under these earlier Orders, the Commission consistently applied a single test – the prudence standard – that guided PSE in its efforts to manage the Tenaska resource. In the Tenaska Order, however, the Commission adds yet another test – an economic "used and useful" component. In the process, the Tenaska Order takes the 1992 Tenaska contract costs and makes them into a retrofitted "benchmark" for the purpose of determining, in later "look-backs," whether PSE can recover all of the costs associated with the Tenaska asset. Most significantly, the Commission applies the new economic test and the 1992 benchmark to impose multi-million dollar disallowances retroactively -- years after PSE made the fuel management decisions that were challenged in this proceeding.

This sort of *ex post* change in regulatory policy presents significant legal problems.[29] It violates the basic tenet of a reasonableness review – namely, that review of a utility's resource decisions must be conducted from the perspective of information that was available, or reasonably should have been known, when the utility made the decisions. Based upon the Prudence Order and, in particular, the Order that the Commission entered in Docket No. UE-971619, PSE reasonably assumed that future cost recovery for the Tenaska asset would continue to be determined based on prudence, *not* on the application of an economic net benefits test applied for the first time in 2004. PSE did not know and could not have known that the Commission might someday decide to retroactively apply a new test and cost benchmark to the Tenaska asset. As discussed in the next section of this Petition (which reviews the policy ramifications of the new test), PSE likely would have made different resource decisions had it known that the Commission could or would apply an economic test to those decisions.

PSE is aware that the Commission may under RCW 80.04.210 rescind, alter, or amend its prior orders and rules. But this statute requires at least some degree of due process, by conditioning a change to a rule or order upon notice to the affected utility and an opportunity

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[29] The Supreme Court has stated that a regulatory commission's decision to "arbitrarily switch back and forth between methodologies…would raise serious constitutional questions." *Duquesne Light Co. v. Barasch*, 109 S.Ct. 609, 619, 488 U.S. 299 (1989) (hereinafter *Duquesne*).

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to be heard. No such notice has been given here. Nor has PSE been given the opportunity to fully brief the new economic test or the 1992 cost benchmark, or to present evidence concerning the impact of the test and the benchmark upon PSE's past and future resource decisions. Under these circumstances, the retroactive imposition of multi-million dollar penalties -- based on standards never before articulated in this state – violates fundamental notions of fairness, due process, and ratemaking principles.

B. The New Economic Test Represents Bad Public Policy That Will Hurt Washington Utilities And Their Customers.

Besides being weighted with the legal infirmities described above, the new economic test that the Tenaska Order articulates represents bad policy for this state. The new test eclipses the Commission's established prudence standard; compromises the Commission's least cost planning standard; increases uncertainty for the electric industry; increases costs for utilities and their customers; and imposes asymmetric risks that are inequitable. For these additional reasons, the Commission should reconsider the Tenaska Order and strike its references to, and reliance upon, the new economic net benefits test.

1. The New Test Effectively Supersedes The Commission's Established Prudence Standard.

The new economic test indisputably departs from the Commission's historical use of, and reliance upon, a prudence standard to evaluate utility resource decisions. As such, it effectively supersedes a proven and workable review standard.

Until it entered the Tenaska Order, the Commission had expressed a single and consistent standard for reasonableness reviews. Resource decisions were evaluated for prudence based on a point-in-time assessment, *i.e.*, according to the "data and methods that a reasonable management would have used at the time the decisions were made."[30] This

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[30] *WUTC v. Puget Sound Power & Light Co.*, Docket No. UE-921262, *et al.*, Nineteenth Supplemental Order (September 27, 1994) at 10) (citations omitted) (hereinafter "Prudence Order").

standard has been in place in Washington State for over two decades, with no change before this proceeding.[31]

Now, however, the Commission has adopted an entirely different standard. An economic test to determine cost recovery effectively trumps the Commission's historical prudence standard. In essence, this test represents a hindsight, results-based review in disguise: did the decision "pan out" economically? Under such a test, *it no longer matters that a resource decision is prudent when made, because the decision's costs will still have to be compared to its economic "benefits" (measured according to a later-determined cost benchmark[32]) at indeterminate review points in the future*.

This sort of "look-back" approach will cause regulatory uncertainty.[33] It will effectively prevent PSE and other Washington utilities from ever having confidence that their costs will be judged reasonable for purposes of rate recovery. One commentator has noted that, because an economic test "implements a regulatory policy under which prudently incurred costs can be disallowed any time in the future," the test creates cost uncertainty for a utility: "A specific cost incurred could be excluded from a utility's cost of service, whether or not prudently incurred, if it turned out to be anything other than the least cost option based on developments in the market occurring well after the acquisition was made…*Therefore, the reasonableness of the entire cost may never be fully or finally determined*."[34]

Other regulatory commissions and courts have discussed the significant problems that are associated with an economic variant of the used and useful standard. In one proceeding, the Massachusetts Department of Public Utilities ("MDPU") considered issues that related to the impact of various ratemaking alternatives on new utility investment. The MDPU concluded that an economic variant of the used and useful standard was "…*impracticable;*

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[31] *See, e.g.*, the *Water Power* decision discussed earlier in this Petition, in which the Commission rejected the economic used and useful test.

[32] Under the Tenaska Order, the benchmark for determining Tenaska-related "benefits" is the 1992 cost level for the Tenaska contract, less the 1.2% disallowance that the Commission imposed in the Prudence Order. *See, e.g.*, Tenaska Order at ¶ 29.

[33] The uncertainty that the new economic test creates is discussed in more detail in Section II(B)(3) of this Petition.

[34] Lesser at 360 (emphasis added).

inconsistent with economic efficiency, the obligation to serve, and the avoidance of bias in the decision-making process…[and] jeopardized efficient provision of service by creating financing barriers for utility projects…"[35]

Another proceeding involved an order by the Montana Department of Public Service Regulation ("MDPSR") that denied rate recovery to the Montana Power Company for the Company's costs associated with its investment in a share of the Colstrip 3 generating station.[36] On appeal, the Montana District Court overturned the MDPSR's order as "unreasonable, arbitrary, and clearly erroneous."[37] One commentator has characterized the court's decision as follows: "[T]he Court not only rejected the Department's decision on the requirements to meet a prudence standard, it also rejected a market-based standard for used and usefulness for which no competitive market existed and which was applied selectively, *penalizing a utility for a supposedly above-market resource while not rewarding it for below-market resources*."[38]

The Commission should follow the established weight of authority in Washington State and forty-eight other state regulatory jurisdictions[39] and decline to apply the new economic test that the Tenaska Order articulates. "Economic used and usefulness is not an inevitable evolution of the traditional used and useful test, nor should it be. When a utility makes a resource acquisition decision, whether PPA or a nuclear plant investment, *the prudence test provides a well-established framework for evaluating efficiency and equity…[A]n economic used and useful test [should not] be used to second-guess, or otherwise impose impossible standards of conduct on, utilities*."[40]

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[35] *In Re Pricing And Rate-making Treatment For New Electric Generating Facilities Which Are Not Qualifying Facilities*, 89 P.U.R.4th 190, 191 (Mass. 1986) (hereinafter "*MDPU Proceeding*") (emphasis added).

[36] *In Re Montana Power Co*., 61 P.U.R.4th 177 (Mont. 1984).

[37] *Montana Power Co. v. Mont. Dep't of Pub. Serv.*, 68 P.U.R.4th 521, 526-27 (Mont. 1985).

[38] Lesser at 362 (emphasis added). This problem of asymmetric risks -- caused by the inequitable application of an economic cost recovery test -- is a significant problem with the Tenaska Order. *See* the discussion in Section II(C) of this Petition.

[39] Dr. Lesser describes Vermont as the "only state to currently apply economic used and useful tests to PPAs with any regularity." In his opinion, "those applications have not only been baffling, they have stood the regulatory symmetry principle on its head." *See* Lesser at 365. Not surprisingly, the asymmetric risks that the economic test has imposed upon Vermont utilities have had "catastrophic financial results." *Id.* at 365-366.

[40] *Id.* at 378 (emphasis added).

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2. The New Test Compromises The Commission's Least Cost Standard, Including The Portfolio Approach To Least Cost Planning.

WAC 480-100-238 requires a utility to engage in long-term economic analyses and processes to ensure that it meets its load with a mix of least cost generation resources over the long term. Consistent with the least cost standard, PSE has expended a great deal of effort to develop a comprehensive resource strategy.[41] The new economic net benefits test will compromise this least cost approach and, in so doing, could lead to decisions and strategies that are not least cost – resulting in potentially higher costs for utilities and their customers.

Under the new test, PSE and other utilities will have to ask themselves the following fundamental question before they make a resource decision: "Is the decision likely to create net "benefits" for the public under all ranges of possibilities *in all relevant future time periods*?" No longer will utilities attempt to use analytical tools to assess net risk, costs and benefits with the ultimate goal of identifying the least cost mix of resources. Rather, they will be forced to select resources that pose little or no price risk over time so as to avoid possible disallowances (such as the disallowances that the Tenaska Order imposes regarding the Tenaska asset).

Figure 1 illustrates how this switch in decisionmaking is likely to occur. In this hypothetical, a utility has two choices for gas supply for a generation plant: a fixed priced contract (Contract A), and a variable priced contract (Contract B) for which the utility has estimated both a range and an expected cost.

[41] *See generally* Exh. No. 101 (Testimony of Charles J. Black) and Exh. Nos. 3 and 4 (collectively, PSE's 2003 Least Cost Plan).

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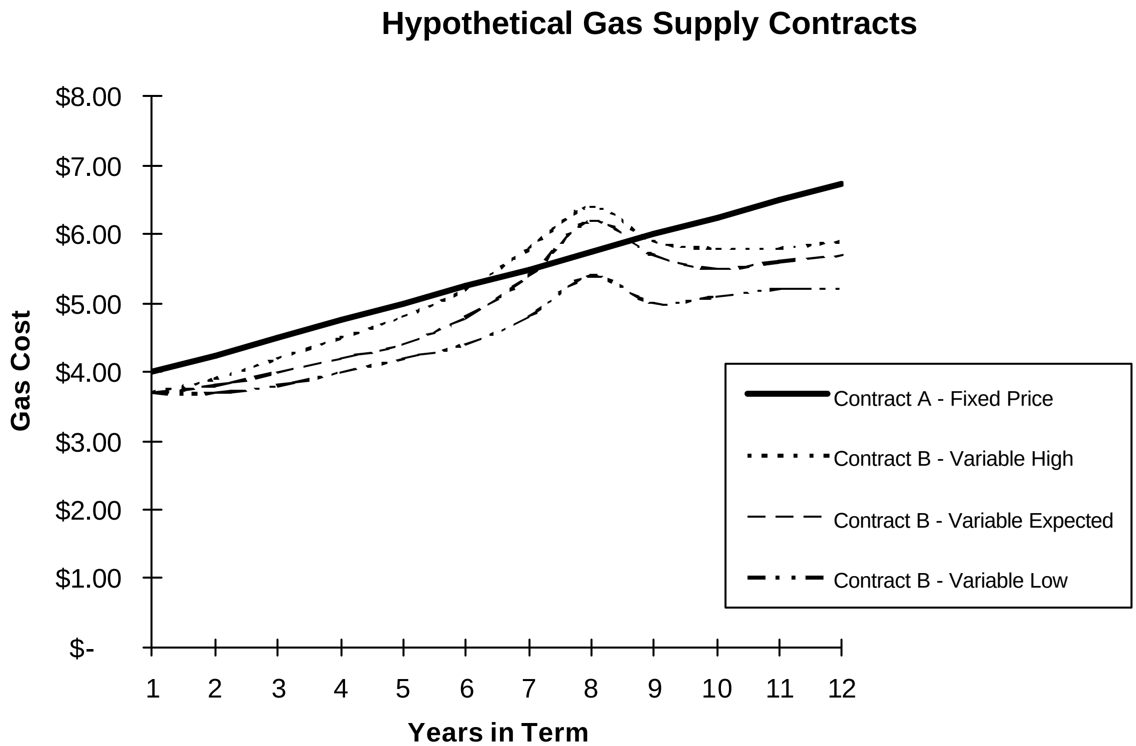

Under prudence and least cost standards, the utility would under this hypothetical decide to execute Contract B because that decision would likely result in the least cost fuel over the contract term. But if the utility believes that an economic test may apply, then it would have to choose between a contract that meets the prudency and least cost standards (Contract B) and a contract that meets the economic test by producing net economic benefits in all future time periods (Contract A).

In making this decision, the utility would ask itself what would happen if, during a rate review inquiry in year 8, the contract prices are as high as the utility expects. The utility would conclude that, because an economic test would determine cost recovery, the Commission would likely impose a disallowance for that time period and in rates going forward *even though Contract B actually meets the prudence and least cost standards*. Given this significant risk, the utility would likely choose Contract A – the fixed price alternative – even though it is the more expensive option on a net present value basis over the comparative term. This is predictable, since no prudent utility will *ever* sign a resource contract knowing that the contract creates the likelihood or even the possibility of a future cost disallowance (based on the application of an economic test). Both the utility and its customers end up paying more under this scenario.

The portfolio approach to least cost planning would also be compromised under the new test. This approach analyzes an entire portfolio of resources, and their associated risks, in order to obtain a least cost mix of resources pursuant to WAC 480-100-238. Diversification of resource types is important because it helps a utility to manage its overall costs and risks and other system-wide considerations. Under the Tenaska Order's new test, however, if a utility projects a possible disallowance for a particular resource at some future time (by comparing economic benefits to costs), then it will likely decide *not* to add that resource to its portfolio even though the resource otherwise complements the portfolio and reduces the portfolio cost. This would defeat the purpose of a portfolio approach to least cost planning and skew portfolios away from otherwise beneficial resources that may, under the economic test, create the risk of a future cost disallowance.[42]

Finally, the new test dictates a very narrow definition of "economic benefits." It judges a resource by a single standard in a single review period. In so doing, the test ignores the economic notion of analyzing a resource's cumulative costs and benefits over the *entire contract term* using net present value. (As an example, Figure 1's Contract B has a lower total cost over the contract term under any of the three pricing scenarios, but would fail the economic test in year 8.) The test ignores a resource's underlying economic value, and instead measures economic "benefits" through an accounting comparison to a hypothetical alternative. The economic value of a portfolio of resources, comprised of a number of projects with distinct cost, benefit and risk characteristics, cannot be measured meaningfully by such a

[42] *See* Lesser at 370-375 (discussing how the economic used and useful test would affect a utility's least cost planning efforts).

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single measure of economic value at a single point in time. Therefore, the new test fails to consider and apply more appropriate measures of economic value.[43]

3. The New Test Adds Uncertainty To The Electric Industry And Will Increase Costs For Utilities And Their Customers.

Mr. Markell testified at hearing about the uncertainty that currently exists in the electric industry.[44] The Tenaska Order's new economic test will add a whole new level of uncertainty, with the following consequences among others:

- Utilities will be dissuaded from contracting for long-term resources because, over the extended life or term of the resource, a possibility will exist that the Commission could order a significant disallowance based on the resource's lack of net economic "benefits" in a particular review period. (On this note, PSE would have experienced significant disallowances on its Mid-Columbia hydropower contracts if an economic test had been applied to those contracts in their initial years.)

- Utilities will be wary about investing in capital facilities because many such facilities are not "in the money" in the beginning of the financing term – which means that these facilities could face an immediate disallowance under an economic test.

- Utilities will lose negotiating leverage in contract negotiations; their counterparties will know that the utilities face the possibility of future disallowances under certain contract arrangements, and will adjust their negotiating positions accordingly.

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[43] Even Vermont – the sole adherent to the economic used and useful test (according to Dr. Lesser) – agrees that the test should be applied by measuring net present value over a contract term. The Vermont Public Service Board has stated that an investment or purchase decision is not used and useful "when it is not expected to yield *net present value benefits, after consideration of non-price benefits, over its lifetime*." *See In Re Green Mountain Power Corp.*, 184 P.U.R.4th 1, 19 (Vt. 1998) (emphasis added).

[44] TR. 107: 5-10 (Markell).

- Greater uncertainty over the prospect of cost recovery will create "financing barriers for utility projects" and will increase the cost of capital for utilities.[45]

These consequences, taken together, will increase a utility's costs to provide electric service. Ultimately, these higher costs will be borne by customers.

C. The New Test Is Inequitable As Applied Because It Imposes Asymmetric Risks.

In addition to the legal infirmities and adverse policy implications discussed above, the new test is inequitable because it imposes asymmetric risks upon PSE.

When an economic test is applied, "[U]tilities can never fully know whether their actions are reasonable *or where their shareholders may be exposed to asymmetric risks*."[46] Such risks arise where a regulator imposes a disallowance based on above-market costs, but fails to permit the utility to benefit from "an advantageous purchase decision – at most [the utility] will be able to recover its cost."[47] The utility faces a "lose-lose" situation that is similar to the situation discussed earlier in this Petition involving the Montana Power Company and the asymmetric order that the MDPSR imposed.[48] The Supreme Court has observed that the creation of asymmetric risks under a regulatory order raises the possibility of "serious constitutional questions."[49]

These risks arise under the Tenaska Order. Under the Commission's recovery rule, if the Tenaska costs are deemed prudent in any given review period between July 2003 through 2011, but the total costs exceed the benchmark determined by the original 1992 contract costs for that particular period, then PSE will have to forfeit half of the return on the Tenaska asset. Conversely, if the costs are deemed prudent in a review period and the total costs fall below

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45 *MDPU Proceeding* at 191; *see generally* Lesser at 375-376.
46 Lesser at 361 (emphasis added).
47 *Id.* at 360.
48 *See generally Id.* at 376-378 and the discussion in Section II(B)(1) of this Petition.
49 *See Duquesne* at 619 ("[A] State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions").

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the benchmark (which PSE anticipates they will before 2011), then PSE can only recover its authorized return on the Tenaska asset in that period, with no possibility of realizing any additional return due to its successful fuel management efforts. Moreover, *even if by 2011 the net effect of the Tenaska buyout over its life proves to be favorable to PSE's customers,* PSE's shareholders will by then have forfeited millions of dollars of return on their investment in that asset.

In other words, PSE's customers pay significantly less than 100% of the authorized return on the Tenaska asset if the costs exceed the benchmark, but gain 100% of the potential benefits if those costs fall below the benchmark. On PSE's side of the cost equation, and *even if all its costs are deemed prudent*, PSE is denied full recovery if the costs exceed the benchmark, and receives no potential benefits if those costs fall below the benchmark.

If the "one-time" disallowance of $25.6 million is intended to address all past prudence issues, and the Commission intends to review prudence from a "clean slate" going forward, then the balance of risks and benefits should be equalized. As currently written, the recovery rule for future Tenaska costs gives too great a benefit to customers at PSE's expense.

Attachment A to this Petition is a chart that illustrates how the imbalance occurs under the Commission's Tenaska Order. The attachment represents a rough approximation (for illustrative purposes only) of the total Tenaska costs from the beginning of the PCA Period 1 (July 1, 2002) to date and projected through the end of the contract term. The original contract, 1.2% disallowance, and benchmark ("Original Contract") are also plotted. Attachment A also shows the period in which the Commission has imposed the $25.6 million disallowance and the 50% under-recovery on the asset's return.

At some point (around PCA Period 6 in 2007 in this hypothetical), PSE anticipates that the total contract charges will fall below the baseline. The area thereafter -- between the benchmark (blue line) and the total current contract costs net of disallowances (green line) -- represents a substantial benefit to customers. The Commission's economic benefit test creates two problems, which are shown on Attachment A: (1) PSE and its customers share the costs that exceed the benchmark, but the customers get 100% of the benefits when the costs are less than the benchmark; and (2) the short time period in which the benefits are measured denies PSE the opportunity to receive benefits that offset the disallowed return on the asset.

PSE has maintained it expects more than half of the Tenaska benefits to occur in the later years of the Tenaska contract.[50] Yet due to the Commission's imposition of an isolated, period-by-period economic test, PSE loses the opportunity to manage its gas costs in a manner that reduces the effect of disallowances over the remaining contract term.

D. PSE's Suggested Remedy.

The Commission should remove the new economic net benefits test from the Tenaska Order and, in the process, eliminate or significantly reduce the related disallowances. The Commission's ability to fashion a remedy under its prudence standard does not require adoption and application of an entirely new standard. If the Commission desires to develop and apply such a new standard on a going-forward basis to new resources acquired in Washington State, then it should issue a notice and schedule appropriate proceedings to receive input from the regulated community, Commission Staff, the Attorney General's office, and the public.

In the alternative, and at a very minimum, the Commission should permit PSE and its customers to share equally the benefits of fuel costs that fall below the cost benchmark – since PSE and its customers share the costs that exceed the benchmark. This could be achieved by allowing PSE to defer, over the remaining contract term, any 50% disallowance on the return on the Tenaska asset, to be reduced by any savings that occur when the total fuel management costs for the asset are less than the benchmark. Any write-offs would only occur if the deferred disallowances are greater than benefits (less costs than benchmark) at the end of the contract.[51]

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[50] TR. 324:10-16 (Gaines).

[51] Attachment D to this Petition shows that, if the Commission permits PSE to defer costs disallowed under the Tenaska Order (as provided in ¶ 95 therein) for possible future recovery when benefits occur in the later years of the Tenaska contract, then the impact on the revenues will amount to what the Commission appears to have intended: a one-time disallowance of $25.6 million.

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III. CLARIFICATION OF ACCOUNTING ISSUES.

PSE requests that the Commission clarify certain uncontested accounting issues and (to the extent that the disallowances are not reversed) clarify how the disallowances should be implemented today; how the disallowances will affect PCA Period 2; and what the Tenaska Order disallowances mean for future rate periods.

A. Uncontested PCA Accounting Matters.

At the post-order conference on May 17, 2004, PSE sought clarification of several accounting matters related to the calculation of the PCA. Commission Staff agreed that the following treatment was appropriate under the Tenaska Order, and no other party objected. PSE respectfully requests that the Commission confirm and authorize this treatment:

1. The actual Frederickson 1 costs should be added to the PCA calculation as of the day after closing (April 30, 2004) -- *i.e.*, the first full day that PSE began taking energy from the Frederickson 1 facility.

2. All of the non-Frederickson 1 uncontested and unchanged cost adjustments in the PCA calculation (Adjustments 1 – 2 and 4 – 13) should be used for purposes of calculating the PCA effective April 7, 2004, the day after the Commission entered Order No. 12 in this proceeding. (The Commission stated in Order No. 12 that these adjustments were not at issue, but – in Order No. 13 – withheld final approval of the adjustments pending the resolution of the Tenaska issue.)

3. The new Power Cost Baseline for PCA purposes should become effective on the same day that the rates go into effect (May 24, 2004).

4. The Commission should expressly approve and authorize the accounting treatment for the White River Project that underlies the approved Adjustment 9. Specifically, PSE requests that the Commission approve PSE's and Commission Staff's proposal to defer the remaining undepreciated plant costs

as a regulatory asset and to continue amortizing these costs at the current depreciation rate until better information is known related to sales and salvage values associated with this property.

B. Implementation Of The Disallowances.

If the Commission does not reconsider the Tenaska Order, then PSE asks the Commission to clarify how the disallowances should be implemented. The accounting and ratemaking treatment of the disallowances are significantly complicated by the PCA mechanism. While the Commission appears to have intended a $25.6 million "one-time" disallowance, the actual write-off and under-recovery of costs resulting from the Tenaska Order could be more than $42 million through December 2004 under an application of the Tenaska Order as currently written and applied to the PCA mechanism. Consequently, PSE asks the Commission to clarify its intent concerning how the disallowances should be implemented in the PCA mechanism accounting.

In order to understand what type of filings and proceedings will be required for the second PCA annual filing in August 2004, PSE also asks the Commission to clarify how the Tenaska Order affects PCA Period 2, *i.e.*, the period from July 1, 2003 through June 30, 2004.

1. Effect Of The Tenaska Order On The First 10.5 Months Of PCA Period 2 (July 1, 2003 Through May 13, 2004).

The Tenaska Order states that the $25.6 million disallowance for PCA Period 1 is intended to be a "one-time disallowance of costs on which the mechanism operates" in order to "account for the Company's imprudent management through the test period [7/02 thru 6/03]."[52] The Tenaska Order further states that its cost recovery rule "[determines] recovery of Tenaska costs incurred *after the effective date of this Order*."[53] The combination of these quoted provisions suggests that the Commission did not intend to insert additional

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[52] Tenaska Order at ¶ 94; *see also Id.* at ¶ 101 (dispute for PCA Period 1 resolved "through a one-time disallowance").

[53] *Id.* at ¶ 86 (emphasis added).

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disallowances into the PCA accounting under its cost recovery rule for the time period between July 1, 2003 and May 13, 2004.

Despite these provisions, however, the Tenaska Order goes on to state that the "costs incurred between July 1, 2003 and the date of this Order remain subject to review in an appropriate proceeding."[54] This time period, however -- the first 10.5 months of the 12-month PCA Period 2 -- has already occurred.

This means that PSE faces the risk -- indeed a near certainty -- of an additional $10 million write-off associated with the Tenaska asset for the first 10.5 months of PCA Period 2, assuming that the Commission allows PSE to recover only 50% of the return on the Tenaska asset for this period. As illustrated in **Attachment B** to this Petition, the effect of the Tenaska Order, if left unclarified on this matter, is $42.9 million of total impact in 2004 -- not just the $25.6 million "one-time" disallowance that the Tenaska Order imposed. PSE questions whether the Commission intended such a severe impact.

Attachment C to this Petition shows that, if the Commission refrains from imposing the 50% return limitation during the first 10.5 months of PCA Period 2, then the impact on revenues will be reduced to $32 million in 2004. While this is still significant, it may be more in line with the Commission's intent with respect to the disallowance.

Finally, **Attachment D** to this Petition shows that, if the Commission permits PSE to defer unrecovered returns for possible recovery when benefits occur in the Tenaska contract's later years, then the impact on revenues will amount to what the Commission appears to have intended: a one-time disallowance of $25.6 million.

Obviously PSE cannot "turn back the clock" for the first 10.5 months in PCA Period 2 that have already occurred. Nor can PSE unwind the fuel management decisions that PSE made before PCA Period 2, which determined the costs for these 10.5 months with respect to the potential impact of long-term, fixed price fuel supply contracts. It would be unfair, in a future review proceeding, to retroactively apply the 50% return limitation to that portion of

[54] *Id.* at n. 104.

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PCA Period 2 that occurred before the Commission entered the Tenaska Order. Thus, the 50% return limitation should not apply to PSE's PCA Period 2 costs incurred through May 13, 2004.[55]

For these reasons, PSE respectfully requests that the Commission clarify that the Tenaska Order does not impose the 50% return limitation during the first 10.5 months of PCA Period 2 *on top of* the "one-time" disallowance of $25.6 million. If the Commission does decide to impose a 50% return limitation, then PSE requests that the Commission allow it to defer those returns for possible later recovery when offsetting net benefits that may occur in the Tenaska contract's later years, as discussed in Section II(D) of this Petition.

2. Impact Of The One-time Disallowance On PCA Period 2 And Future Periods.

PSE also asks the Commission to clarify how the Tenaska Order's "one-time" disallowance applies to the fuel management decisions that PSE made before PCA Period 2 began – *i.e.*, before July 1, 2003. PSE is concerned that other parties may argue in future proceedings that the impacts of these decisions have affected costs in PCA Period 2 and in future review periods. The Commission should clarify that PSE's fuel management decisions before July 2003 have been fully addressed in the Tenaska Order and are no longer relevant to cost reviews for PCA Period 2 or future review periods.

The Commission received evidence and briefing in this proceeding concerning PSE's risk management activities from the mid-1990s through the hearing dates in February 2004. If fuel management decisions made before July 2003 remain relevant to future cost reviews, then PSE is concerned that other parties will cite the Tenaska Order's findings in future review periods with the *same history of management decisions as PCA Period 1* and argue for a complete write-off of the return on the Tenaska asset *during those future periods*. PSE should not be subjected to the financial uncertainties associated with such future potential arguments

[55] The Commission may decide that, because PCA Period 2 will end very shortly (on June 30, 2004), the 50% return limitation should not apply to any of the costs in that period – not just to the costs incurred through May 13, 2004. That approach would be preferable to PSE.

for further disallowances based on the same decisions that led to the disallowance for PCA Period 1. Consequently, the Commission should clarify that the "one-time" disallowance in the Tenaska Order creates a "clean slate" with respect to the fuel management decisions that PSE made before PCA Period 2 began – *i.e.*, before July 2003 -- even though those decisions may, arguably, affect fuel costs during PCA Period 2 and in future review periods.

3. Future PCA Compliance Filings.

Finally, PSE requests that the Commission provide further clarification with respect to the compliance filing it anticipates for PCA Period 2. As described above, the Commission received evidence in this proceeding concerning PSE's fuel management efforts through February 2004. The Commission criticized PSE primarily for not having, in the Commission's opinion, a strategy for the Tenaska resource that included long-term, fixed-price gas contracts.[56] As a practical matter, therefore, the Commission has already reviewed the prudence of PSE's fuel management efforts for PCA Period 2 insofar as those efforts relate to long-term contracts.

PSE therefore respectfully suggests that, with regard to the annual compliance filing for PCA Period 2 (scheduled for August 2004), there should be no need for PSE to file evidence concerning its fuel management efforts or for the parties to litigate another prudence proceeding, most of which would duplicate portions of the proceedings concluded in the Tenaska Order. In essence, if the economic benchmark test is to be applied to PCA Period 2, then the filing for that proceeding should be an accounting filing in which the prudence of PSE's fuel management costs are not at issue; instead, the question will simply turn on an application of the Commission's cost recovery rule to the return on the Tenaska asset. If that rule is not modified as a result of PSE's reconsideration request, above, then the result would be a maximum disallowance of 50% of the return on the Tenaska asset for PCA Period 2.

[56] *See, e.g.*, Tenaska Order at ¶ 91.

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In the future, and beginning with the August 2005 annual compliance filing for PCA Period 3, PSE would anticipate prefiling evidence as to its fuel management efforts that occur after early 2004, for review and evaluation by the Commission and the parties.

PSE requests that the Commission clarify these issues to provide direction to PSE with respect to its August 2004 PCA compliance filing and to the parties that may be involved in that proceeding.

IV. CONCLUSION.

Judge Starr stated in *Jersey Central* that utility regulation continues to be a "compact of sorts" that has to balance the needs and interests of both utility investors and ratepayers.[57] The Commission's new economic test, however, "does not balance these needs. By failing to do so, [the test] will ensure greater inefficiency and inequity, to the ultimate detriment of both ratepayers and utilities."[58]

For these reasons, and for the other reasons stated in this Petition, the Commission should not adopt a new economic test for reviewing resource decisions of the utilities it regulates. The Tenaska Order should be reconsidered and clarified as requested in this Petition.

DATED: May 24, 2004

Respectfully Submitted,

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[57] *Jersey Central* at 1189.

[58] Lesser at 379.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that I have this day served PSE's Petition for Reconsideration and Clarification of Order No. 14 upon all parties of record in this proceeding, by U.S. mail, postage prepaid and/or fedex overnight delivery:

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Signed at Seattle, Washington this 24th day of May, 2004.

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