

EXHIBIT NO. ___(EMM-6CT)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: ERIC M. MARKELL

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

Docket No. UG-040640
Docket No. UE-040641
(*consolidated*)

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

For an Order Regarding the Accounting
Treatment for Certain Costs of the Company's
Power Cost Only Rate Filing.

Docket No. UE-031471 (*consolidated*)

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

For an Accounting Order Authorizing
Deferral and Recovery of the Investment
and Costs Related to the White River
Hydroelectric Project.

Docket No. UE-032043 (*consolidated*)

PREFILED REBUTTAL TESTIMONY OF
ERIC M. MARKELL (CONFIDENTIAL)
ON BEHALF OF PUGET SOUND ENERGY, INC.

NOVEMBER 3, 2004

REDACTED
VERSION

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PUGET SOUND ENERGY, INC.

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PREFILED REBUTTAL TESTIMONY OF ERIC M. MARKELL

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CONTENTS

4 I. INTRODUCTION1

5 II. II. ELECTRIC RESOURCE ACQUISITION UPDATE3

6 III. RESOURCE PLANNING AND ACQUISITION EXPENSES9

7 IV. DECOMMISSIONING OF THE WHITE RIVER HYDROELECTRIC
8 GENERATING PROJECT13

9 V. COLSTRIP COAL PRICES17

10 VI. CANWEST NATURAL GAS SUPPLY CONTRACT20

11 VII. LONG-TERM GAS PRICE FORECAST23

12 VIII. CONCLUSION25

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF ERIC M. MARKELL

I. INTRODUCTION

Q. Are you the same Eric M. Markell who submitted prefiled direct testimony in this proceeding on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. My rebuttal testimony:

- i) provides an update regarding the Company's efforts to acquire additional electric resources in support of the Company's response to the testimonies of Staff witness Dr. Wilson and Public Counsel witness Mr. Hill;
- ii) provides a description of professional services the Company used during the test year related to its resource planning and acquisition processes and their relationship to related expenses expected to be incurred during the rate year, in response to Mr. Schoenbeck's testimony on behalf of ICNU;

- 1 iii) updates information regarding the program of decommissioning
2 and asset disposition being pursued for the White River
3 Hydroelectric Project in response to the accounting treatment
4 proposed by Mr. Russell of Commission Staff for that project,
- 5 iv) updates information regarding changes in delivered coal costs to
6 the Colstrip Steam Electric Generating Plant Units No. 1, 2, 3, & 4,
7 and provides a description of the contractual provisions in the coal
8 supply contracts that give rise to such changes, in response to
9 Dr. Mariam's testimony on behalf of Commission Staff;
- 10 v) explains why the projected cost of natural gas during the rate year
11 changed, in relation to a new development with the Company's
12 CanWest Gas Supply Contract and related replacement supply
13 agreements; and
- 14 vi) provides a description of the proper use of the long-term gas price
15 forecasts cited by Mr. Schoenbeck in his testimony for ICNU.

16 **Q. Please summarize your rebuttal testimony.**

17 A. First, PSE will need significant capital over the next several years to acquire
18 electric resources needed to serve its customers. Such resource needs are
19 described in my direct testimony, Exhibit No. ___(EMM-1CT), at 3-8. Given the
20 current state of our resource acquisition effort, PSE will likely require between
21 \$████ million and \$████ million of external capital during the rate year to fund
22 its acquisition of new electric supply resources.

1 Second, ICNU's recommendation to remove \$2.6 million associated with outside
2 consulting expense is based on mistaken assumptions regarding the work
3 performed by Navigant Consulting.

4 Third, the program to decommission and dispose of the White River
5 Hydroelectric Project is reasonable, and the accounting treatment for existing and
6 future costs of such program proposed by Commission Staff is reasonable.

7 Fourth, the projected cost of coal for Colstrip Generating Units No. 1 and 2 and
8 Units No. 3 and 4 from cost-based coal supply agreements used in the Company's
9 presentation of the rate year power costs reflects the coal cost under the coal
10 purchase agreements, and the changes in coal costs are not a result of a change in
11 coal mine or project ownership as suggested by Commission Staff.

12 Fifth, the cost of gas under the CanWest Gas Supply Agreement during the rate
13 year has changed from the cost estimates first filed in direct testimony of
14 Ms. Ryan due to the anticipatory breach of such agreement by the supplier and the
15 subsequent negotiation of a settlement agreement with such supplier.

16 Sixth, ICNU's proposal to use a long-term gas price forecast to estimate gas prices
17 during the rate year is unreasonable.

18 **II. ELECTRIC RESOURCE ACQUISITION UPDATE**

19 **Q. What action is the Company taking to meet its long-term resource needs?**

20 A. My direct testimony, Exhibit No. ___(EMM-1CT) at 6-9, describes the

1 Company's long-term resource acquisition program to secure low-cost power
2 supplies to replace expiring contract resources and to provide for its growing
3 customer requirements. Subsequent to the filing of such testimony, the Company
4 has completed the acquisition of a 49.85% interest in the 249 MW Frederickson
5 Unit No. 1 electric generating facility located near Tacoma, Washington which
6 transaction closed on April 29, 2004.

7 Furthermore, the Company has continued to evaluate potential additional resource
8 acquisitions under the three Requests for Proposal described in my direct
9 testimony: (i) a Wind Resource RFP, (ii) an All-Source RFP that seeks 355 aMW
10 of new electricity resources and, (iii) an RFP for conservation resources.

11 **Q. What is the current status of the Conservation RFP?**

12 A. The Company issued an RFP for acquisition of energy efficiency resources in
13 parallel with the Wind and All-Source RFP's. The Company has been working
14 closely with its Conservation Resource Advisory Group ("CRAG") to scope the
15 elements and timing of an energy efficiency resource acquisition program. The
16 CRAG includes a number of key stakeholders interested in providing guidance in
17 such activity. Letters of Interest to pursue definitive contracts with vendors have
18 been issued for five projects, totaling 7 aMW. Implementation of two
19 conservation projects is scheduled for 2005 and implementation of the remaining
20 three projects is scheduled in 2006. An estimate of the capital requirements that
21 might be required from activity such as accelerated fuel switching programs has
22 not yet been made.

1 **Q. What is the current status of the Wind RFP and the All-Source RFP?**

2 A. The Wind and All-Source RFP evaluation processes merged into a single
3 combined evaluation effort. Such evaluation identified a short list of leading
4 alternatives from each RFP. After the Stage 1 evaluation of nearly 50 proposals,
5 seven projects were selected for a more detailed Stage 2 evaluation. The
6 proposals chosen for the Stage 2 in-depth analysis appear to offer the lowest cost
7 and lowest acceptable risk for obtaining additional electric supply. The proposals
8 selected to the short list involve a mix of renewable and conventional power
9 resources including purchased power from thermal and hydropower sources, and
10 direct investment in the development of wind-powered generating facilities.

11 The selection of the short list was completed on May 13, 2004. Please refer to
12 Exhibit No. ____ (EMM-7C) for a summary of the short list. Stage 2 of the
13 evaluation process is ongoing and preliminary results from the portfolio screening
14 model show the short listed proposals as presenting a relatively low level of cost
15 and risk compared to alternate portfolios. All the short listed proposals are either
16 in service at the present time or have a high probability of being placed in service
17 by late 2006.

1 **Q. What is the current status of the short list selection from the Wind and All-**
2 **Source RFP?**

3 A. On September 1, 2004, the Company executed a Letter of Intent with Zilkha
4 Renewable Energy to obtain a 100% ownership interest in the Wild Horse Wind
5 Power Project located in Kittitas County, Washington. Depending upon the type
6 and configuration of wind turbines ultimately selected and final land acquisition
7 arrangements, such project could be as large as 240 MW of capacity and about
8 80 MW of energy. Such Letter of Intent followed an extensive review process
9 that started with the Wind RFP and continued through the All-Source RFP. The
10 Company is continuing post-proposal evaluations and negotiations with Zilkha
11 and has recently issued a technical request for quotations for price and other terms
12 with qualified wind turbine suppliers. Binding definitive agreements with Zilkha
13 will be signed once the evaluation and negotiation process is complete and
14 internal Company approvals are obtained. Contracts for turbine supply and
15 balance of plant construction will follow. Construction permits are presently
16 expected to be obtained about July 2005 (barring unforeseen developments).

17 **Q. What are some examples of other resource alternatives the Company is**
18 **considering?**

19 A. The Company is actively negotiating with a second wind project developer for
20 interests in a second wind project. The parties' intent is to try to construct such
21 project in 2005 and to place it in service by December 31, 2005. However, a great
22 deal of permitting and other development work must be accomplished on a very

1 tight schedule and wind turbines would have to be available in a very tight turbine
2 supply market in order to allow such project to meet a 2005 commercial operation
3 date. Moreover, the Company must become comfortable that the proposed plan
4 for transmission interconnect and service arrangements with BPA can be timely
5 completed and is commercially sound.

6 Also, the Company is negotiating with a party offering a long-term power
7 purchase agreement and is engaged in commercial discussions with a developer of
8 a small recovered heat project electric generation project.

9 Finally, the Company completed its initial economic and technical assessment of
10 a high BTU landfill gas recovery project that holds the potential to provide a long
11 term stable priced (but relatively small) source of fuel for Company gas fired
12 generation. Such initial evaluations are promising and the Company is
13 considering its options with respect to potential commercial transactions for such
14 technology.

15 **Q. Given events that have occurred since filing of direct testimony in this case,**
16 **can you provide an updated estimate of the capital costs the Company**
17 **expects to incur in 2005 and 2006 with respect to its resource acquisition**
18 **program?**

19 A. Yes. Exhibit No. ___(EMM-8C) illustrates two cases for resource acquisition
20 costs for the thirty-month period July 1, 2004 through February 28, 2006, that I
21 believe present a reasonable range of expected capital needs for new electric
22 resource acquisition during that period. These costs are in addition to the base

1 capital needs of the generation portfolio and the capital requirements related to the
2 implementation conditions of the FERC licenses for the Snoqualmie Falls and
3 Baker Hydroelectric Projects. These costs do not reflect the much greater capital
4 needs beyond February 28, 2006, to meet PSE's growing resource needs.

5 **Q. During the resource acquisition and negotiation process, did the Company**
6 **receive any "credit-related" commercial demands ?**

7 A. Yes. Among various proposed terms and conditions, bidders of power purchase
8 agreements ("PPAs") requested that the Company post supplemental credit
9 assurances to secure its obligations to pay for purchased power under such long-
10 term contracts.

11 **Q. What is the nature of the credit assurances requested?**

12 A. Counterparties requested credit support in the form of a demand letter of credit or
13 cash. Credit provisions are generally reciprocal, that is, the counterparty or PSE
14 would provide to the other contractual access to immediately available funds in
15 the form of a letter of credit or cash to cover the daily mark-to-market exposure
16 (above a certain threshold level) or protect against non-performance or such other
17 events of default that may be specified.

1 **Q. Can you give specific examples of supplemental credit demands made by**
2 **PPA bidders?**

3 A. Yes. In connection with the offer from one potential counterparty for a ten year
4 PPA from its generation plant, the counterparty required a credit facility capped at
5 \$125 million to cover mark-to-market exposure that could be potentially greater.
6 Similarly, a second counterparty initially required supplemental credit support in
7 an amount sufficient to cover the mark-to-market exposure for its proposed 22-
8 year PPA. PSE estimated this exposure to be \$100-\$150 million. PSE's need for
9 credit to support such demands is in addition to the credit requirements described
10 in the testimonies of Mr. Valdman, Mr. Gaines and Ms. Ryan.

11 **III. RESOURCE PLANNING AND ACQUISITION EXPENSES**

12 **Q. Please describe the purpose of this section of your rebuttal testimony.**

13 A. This section of my testimony will respond to the recommendation by ICNU to
14 reduce the Company's revenue requirement by \$2.6 million associated with
15 consulting fees paid to Navigant Consulting ("NCI") during the test year, as
16 described by Mr. Schoenbeck, Exhibit No. ___(DWS-1T) at 27. My testimony
17 will clarify the multiple functions NCI performed and demonstrate that Mr.
18 Schoenbeck's adjustment should not be accepted.

1 **Q. Were the bulk of NCI's charges related to a "one-time event" and capitalized**
2 **as part of the Frederickson 1 acquisition?**

3 A. No. In Exhibit No. ___(DWS-1T) at 27, lines 15-16, Mr. Schoenbeck asserts that
4 ". . . the bulk of the expenses appear to be related to a one-time event and were
5 capitalized as part of the resource acquisition program." In fact, the scope of
6 NCI's work was far broader than assistance with the Frederickson acquisition, and
7 only a small portion of these expenses could be capitalized.

8 **Q. What was the scope of work performed by NCI for the Company during the**
9 **test year?**

10 A. During the period August 2002 through March 2004, NCI was retained to perform
11 five major tasks for the Company. These were the following: (1) provide
12 financial advice and analysis in connection with a competitive procurement
13 process for electric resource acquisition that resulted in the acquisition of interests
14 in the Frederickson Unit No. 1 steam electric plant; (2) perform professional staff
15 work in connection with the design and preparation of the Company's 2003 Least
16 Cost Plan; (3) design and construct financial models for use in integrated resource
17 planning and resource evaluation; (4) perform data assembly and model
18 integration work in connection with the integration of conservation program
19 analytical work products (conservation "supply" resources) into long-term electric
20 resource models; and (5) provide staff assistance in the preparation and review of
21 prudence documentation and regulatory filings for the Frederickson Unit 1 steam
22 electric plant.

1 **Q. How did the Company track such costs?**

2 A. For internal accounting purposes, the Company recorded such costs in three cost
3 centers. For convenience only, these categories were labeled: Resource Strategy
4 and LCP Support, Modeling and Risk Analysis, and Generation Acquisition.

5 **Q. What was the approximate total cost of such services?**

6 A. The total cost of such services was approximately \$ [REDACTED] million.

7 **Q. What portion, if any, of such costs were capitalized during the test year as**
8 **part of the Frederickson 1 acquisition?**

9 A. Approximately \$391,000 of such costs capitalized during the test year in
10 connection with the acquisition of interests in the Frederickson Unit 1 plant.

11 **Q. Would it have been appropriate for the Company to capitalize a higher**
12 **portion of the NCI fees as part of the Fredrickson 1 acquisition?**

13 A. No. As described more fully in Mr. Story's rebuttal testimony, under Statement of
14 Accounting Standards No. 67 ("SFAS No. 67") the Company was not permitted
15 to capitalize any more of such costs than the \$391,000.

16 **Q. Is comparing NCI professional fees during the test year with amounts spent**
17 **for their fees in 2002 a reasonable method for assessing the on-going expenses**
18 **of the Company's resource planning, procurement and acquisition activity?**

19 A. No. Mr. Schoenbeck's underlying premise that the majority of the NCI expenses
20 were for a one-time acquisition that will not be incurred in the future is mistaken.

1 While PSE does not have an ongoing services contract with NCI, the Company
2 has been able to move away from retaining NCI only by significantly increasing
3 staffing resources to internally perform PSE's resource planning, evaluation and
4 commercial work. The Company is presently preparing its 2005 Least Cost Plan
5 (due May 1, 2005) and pursuing extensive resource acquisition activities, some of
6 which are described above. In addition, the Company requires specialized
7 engineering, environmental and legal services to assist its own staff in the due
8 diligence, documentation, development and construction processes associated
9 with a technologically diverse and commercially challenging set of resource
10 opportunities.

11 **Q. What were the Company's expenses associated with resource planning and**
12 **acquisition activity during the test year?**

13 A. The Company's total expense during the test year period for resource planning and
14 acquisition activity was approximately \$3.4 million, which includes NCI costs
15 that were expensed during the period. This all-in cost perspective is important, as
16 NCI expenses were but a portion of the Company's total resource planning and
17 acquisition expenses during the test year.

1 **Q. What do you anticipate the Company will spend on resource planning and**
2 **acquisition activity during the rate year?**

3 A. It is difficult to accurately project an exact number, due to the complexity of
4 resource planning and acquisition work. These areas involve complex modeling
5 and analysis and significant expenditures by outside consultants to ensure
6 resource decisions are properly evaluated. However, as an estimate, the
7 Company's 2005 budget for this activity is approximately \$3.9 million for the
8 calendar year 2005. Thus, the Company plans to increase expenses in this area by
9 roughly \$500,000, not reduce expenses by \$2.3 million as suggested by
10 Mr. Schoenbeck.

11 **IV. DECOMMISSIONING OF THE WHITE RIVER**
12 **HYDROELECTRIC GENERATING PROJECT**

13 **Q. Do you support the proposed accounting treatment for the former White**
14 **River Hydroelectric Project presented in Mr. Russell's testimony?**

15 A. Yes. Mr. Russell's recommendation is reasonable. To aid the Commission's
16 decision, I update below my direct testimony based on events that have occurred
17 since the time the Company filed that testimony.

18 **Q. What is the status of the Company's efforts to analyze and pursue**
19 **alternatives for disposition of the former White River Hydroelectric Project?**

20 A. These efforts are ongoing. The Company recently extended its Memorandum of
21 Understanding ("MOU") with Cascade Water Alliance ("Cascade"), the

1 consortium of municipalities seeking to acquire a new municipal water right and
2 related project assets. The MOU establishes a framework for negotiations
3 between the parties and was extended through March 31, 2005. This extension
4 was given after the Pollution Control Hearings Board (the administrative tribunal
5 hearing the appeal of the new municipal water right) remanded the case back to
6 the Washington State Department of Ecology for further assessment of non-
7 hydropower operations. In return for this extension, the Company secured a
8 commitment from Cascade to share in a broader range of costs associated with
9 preserving and developing assets with the potential for use as a water supply
10 project.

11 The Company also continues to work with the United States Army Corps of
12 Engineers ("COE") to pursue the COE's interest in preserving the White River
13 diversion dam (and related project works) as a fish passage facility. Until
14 recently, it was thought that Cascade would purchase and operate the diversion
15 dam (with some financial participation by the COE) in connection with Cascade's
16 plan to develop a municipal water supply project. However, the COE has now
17 stated its preference to prospectively own and operate the diversion dam. The
18 need to divert for a water supply project will be addressed in a separate contract
19 between Cascade and the COE.

20 The Company is exploring alternatives to sell certain surplus lands, properties that
21 are not needed by Cascade or the COE for water supply or fish passage
22 operations. The Company is obtaining information concerning the value of these
23 lands and is developing a plan to actively market these properties. The United

1 States Fish & Wildlife Service, the Washington State Department of Fish and
2 Wildlife, and various environmental groups have expressed a desire that the
3 Company preserve these lands as wildlife habitat. As part of its marketing plan,
4 the Company will consider sales to one or more entities desirous of preserving
5 these lands for their wildlife value, provided that the Company is able to recoup
6 the value of these properties in any such transaction.

7 The Company continues to work with Pierce County and the Lake Tapps
8 community in connection with their interest to preserve the Lake Tapps reservoir.
9 The reservoir provides significant recreational opportunities to the community and
10 to the region as a whole. Pierce County has advised the Company that it believes
11 that the value the reservoir confers to upland properties supports a substantial tax
12 base. In light of these interests, should the present effort to sell the reservoir to
13 Cascade prove to be unsuccessful, PSE would look to the community and to the
14 County to discern their interest as a potential purchaser.

15 **Q. How is the Company limiting its costs in connection with its efforts to analyze**
16 **and pursue these alternatives?**

17 A. As noted above, in agreeing to extend the MOU with Cascade, the Company
18 secured a broader commitment from Cascade with regard to cost-sharing. As of
19 September 30, 2004, PSE has expended approximately \$4.4 million in pursuit of
20 the new municipal water right and will be reimbursed more than \$4.9 million
21 from Cascade. Such Cascade reimbursement includes a \$3 million extension
22 payment to the Company by Cascade June of 2004.

1 Additionally, when the COE recently renewed its agreement with PSE to operate
2 the diversion dam, it did so with an approved operating budget of nearly
3 \$1 million. While the availability of these dollars is subject to Congressional
4 appropriation, it is anticipated that all or substantially all costs for fiscal year 2005
5 associated with operation of the diversion dam will be reimbursed by the COE.

6 PSE and Cascade are engaged in efforts to settle the appeal of the new municipal
7 water right. Any such settlement would reduce the litigation risk going forward,
8 and hopefully advance the effort to sell project assets to Cascade.

9 In addition to agreements that have been reached or are being negotiated, the
10 Company has taken steps to directly and significantly reduce its operating and
11 maintenance costs. These steps include: reducing labor to the basic need to
12 maintain public safety, dike and dam safety and operation, vegetation
13 management, project asset value, basic maintenance needs for flowline, reservoir
14 shoreline, diversion tunnel, tailrace, and powerhouse flow equipment. The labor
15 force was reduced from 10 FTE's to 4. In so doing, the Company has reduced its
16 O&M costs from an annual expenditure of about \$2,000,000 (when the project
17 was in operation as a hydropower facility) to an annual cost of approximately
18 \$700,000. With regard to any balance that is not reimbursed by the COE, per the
19 terms of the MOU with Cascade, these amounts would be separately reimbursed
20 if Cascade goes forward with its proposed acquisition of the project.

21 **Q. When do you expect to be in a position to complete any one or more of these**
22 **transactions?**

1 A. Cascade is understandably reluctant to close on the acquisition of the new
2 municipal water right, and related project assets, while this water right is on
3 appeal. Taking the uncertainties of this litigation into consideration, I would
4 estimate that completing a transaction with Cascade could take anywhere from 18
5 to 36 months. I would hope that, during this timeframe, the Company may be
6 able to sell some of the surplus lands that are not needed by Cascade or the COE.
7 However, as noted above, the value of these lands is still being assessed and a
8 marketing plan is being developed. Finally, as to the COE's acquisition of the
9 diversion dam, this potentially could occur as early as next year, although the
10 COE has yet to provide proposed terms, or a proposed date, for this acquisition to
11 go forward.

12 **V. COLSTRIP COAL PRICES**

13 **Q. What is the purpose of this section of your testimony?**

14 A. This section of my testimony will provide additional detail to clarify why the coal
15 cost projections during the rate year for Colstrip Units 1 & 2 and 3 & 4 have
16 changed, as mentioned in Dr. Mariam's testimony for Commission Staff at
17 page 27, lines 6-8. Ms. Ryan's testimony will address how such coal prices were
18 used to project power costs.

19 **Q. Why does Dr. Mariam state the cost of coal for Colstrip has changed?**

20 A. At Exhibit T-___(YKGM-1T) at 34, lines 6-9, of his testimony, Dr. Mariam
21 asserts the Company's Colstrip coal prices changed for this reason: "Due to

1 changes in the ownership of the coal production plants and the expiration of
2 existing contracts, PSE had to renegotiate new coal prices."

3 **Q. Does this statement accurately characterize the reasons for changes in**
4 **projected coal prices ?**

5 A. No. I will clarify for the record how the pricing terms in the Colstrip coal
6 contracts operate and why our price estimates for the rate year changed from our
7 estimates in our initial filing.

8 **Q. Please explain why coal prices for Colstrip Units 1 and 2 have changed.**

9 A. Colstrip Units 1 and 2 receive coal produced from Area D of the adjacent
10 Rosebud Mine under a long-term, cost-based contract with Western Energy
11 Company. Delivered coal costs are driven by five main factors. First, Base Price
12 coal costs are adjusted semi-annually to reflect actual, audited cost changes for
13 labor and fringe benefit costs, materials and supplies, explosives and reclamation
14 costs. Second, applicable taxes and royalties due to federal and private
15 landowners measured as a fixed percentage of Base Price costs are then added to
16 Base Price costs to arrive at total coal costs. Third, the scope of mining work to
17 be performed to extract a ton of coal changes with the changing geology of the
18 mine. Generally, the mine is engineered over its life to mine the least cost (lowest
19 stripping ratio) coal first, and the highest cost (highest stripping ratio) coal last.
20 Area D is now in its third decade of development. Stripping ratios are rising.
21 Increasing stripping ratios cause increases in the cost of both coal removal and
22 land reclamation because increasingly larger quantities of material must be

1 handled. And fourth, coal now being mined in Area D is increasingly farther
2 from the power plant coal tipple, thus increasing the distance and cost of hauling
3 coal by haul truck from the working pit to the plant.

4 **Q. Please explain why coal prices for Colstrip Units 3 and 4 have changed.**

5 A. Colstrip Units 3 and 4 receive coal from Area C of the adjacent Rosebud Mine
6 under a long-term, cost-based contract with Western Energy Company. Area C is
7 entering its third decade of development. The coal supply agreement for Units 3
8 and 4 is similar in structure to that of Units 1 and 2, except commodity costs are
9 adjusted quarterly (rather than semi-annually) based on actual mining costs.
10 Fixed costs, such as property taxes and depreciation, are audited and adjusted to
11 actual on an annual basis. As with the Unit 1 and 2 contract, delivered coal costs
12 vary with changes in stripping ratio and haul distance. The Colstrip partners
13 employ an independent coal mining engineer to regularly review least cost mining
14 practices and advise on mine equipment technology and productivity to help
15 assure the best equipment and practices are employed.

16 **Q. Are there other factors contributing to the change in coal prices at Colstrip**
17 **since the case was filed?**

18 A. Yes. Subsequent to the initial filing of this general rate proceeding, the
19 determination of the amount of the 2001 price re-opener was finalized by an
20 arbitrator. The Colstrip 1 and 2 Coal Supply Agreement contains provisions for
21 re-negotiation of the Base Price on the 20th, 25th and 30th anniversary dates of the
22 contract. July 30, 2001, was the 30th anniversary and the Buyers and Western

1 Energy began negotiation of a new Base Price. Unable to reach agreement, the
2 Parties agreed to submit the matter to binding arbitration as provided in the
3 contract. The arbitration panel issued its decision in May 2004, which changed
4 the Base Price of coal. This new Base Price is subject to semi-annual adjustment
5 and to taxes and royalties as described above. As a result of the arbitration,
6 average coal costs during the 2005-2006 period are projected to be \$0.6122 per
7 MMBtu for Units 1 and 2 and \$0.6220 per MMBtu for Units 3 and 4.

8 VI. CANWEST NATURAL GAS SUPPLY CONTRACT

9 **Q. Please describe the purpose of this section of your testimony.**

10 A. This section of testimony will provide an explanation of the CanWest gas supply
11 contract used in the power portfolio, the reason for its early restructuring and
12 termination and actions the Company has taken to replace such gas supply.

13 **Q. Please describe the CanWest gas supply contract.**

14 A. In 1991, Encogen Northwest, which then owned the Encogen combined cycle
15 combustion turbine facility, entered into a long-term gas supply agreement with
16 CanWest--a Canadian producer pool. By way of background, a producer pool is
17 essentially a marketing organization formed to aggregate gas supplies from
18 numerous, often small producers. By aggregating supply, the pool can diversify
19 its production fields and related risks--such risks include high well depletion rates
20 of 20 to 100% per year. By aggregating supply across various producing fields, a
21 pool arguably can enter into longer lived supply contracts with buyers who seek

1 multi-year supply contracts and possibly fixed prices. The CanWest contract
2 supplied 9,300 MMBtu/day for use at the Encogen project at an escalating fixed
3 price (\$ [REDACTED]). The term of the original contract was July 1, 1993 until
4 June 30, 2008. In February, 2004, the management of CanWest informed the
5 Company that CanWest had decided to wind up its affairs by October 2005 and
6 that it did not possess back-to-back supply agreements to meet its post 2005
7 contractual supply obligations to four customers, including PSE. CanWest is a
8 marketing entity that is at present essentially without assets. All but [REDACTED] of
9 CanWest's sales contracts expire before October 2005; similarly, all its contracts
10 for gas supply to the pool expire at the end of October 2005. Accordingly, the
11 pool determined it would wind up its affairs and not secure additional supplies to
12 meet its remaining contractual obligations. PSE was first informed of CanWest's
13 circumstances in February of 2004. PSE has been conducting legal due diligence
14 inquires and commercial settlement negotiations with CanWest since that time.

15 **Q. Were any legal remedies investigated with regard to CanWest's decision to**
16 **wind up its affairs?**

17 A. Yes. PSE retained Canadian counsel and extensively studied its legal and
18 commercial alternatives. The conclusion of these efforts was that PSE had no
19 practical option other than to seek a settlement arrangement with CanWest.
20 Litigation was unlikely to achieve a better result. Not only did a litigation
21 alternative pose uncertain results under Canadian law, it was also estimated to be
22 very expensive due in part to uncertainties posed by the nature of CanWest itself.

1 **Q. What were the terms of the negotiated settlement?**

2 A. PSE has negotiated a settlement value of [REDACTED] of its expected damages and has
3 received a warranty that its settlement, in the aggregate, is [REDACTED]
4 [REDACTED]
5 [REDACTED]. The Company recently executed the settlement
6 agreement (the effective date of the agreement is October 1, 2004). Pursuant to
7 the settlement, the CanWest contract will terminate on October 31, 2005. The
8 settlement's value will be captured by applying a monthly credit to amounts owed
9 for gas received during the remaining term of the amended contract. The
10 expected value of settlement credits is approximately [REDACTED].

11 **Q. Has PSE taken actions to replace the gas supplies that CanWest will no**
12 **longer provide?**

13 A. Yes, PSE's Energy Resources Committee ("ERC") authorized the purchase of
14 5,000 MMBtu/day at Station #2 on the Duke/Westcoast Pipeline and the use of
15 Station #2 prices to establish subsequent purchase triggers for an additional 5,000
16 MMBtu/day should the market prices go up, or down. The ERC-directed strike
17 prices are the Station #2 purchase price plus [REDACTED]/MMBtu should the
18 market go up and less [REDACTED]/MMBtu should the market go down.

19 On October 4, 2004, in compliance with the direction of the ERC, Gas Operations
20 purchased firm physical gas for 5,000 MMBtu/day from November 2005 through
21 June 2008 at Station #2. The price to be paid was [REDACTED]/MMBtu. The
22 subsequent strike prices, established by this purchase, were [REDACTED]/MMBtu,

1 and ██████████//MMBtu. Three days later, PSE purchased the remaining 5,000
2 MMBtu/d on October 7, 2004 at Station #2 at a price of ██████████//MMBtu.
3 This subsequent purchase completed the replacement of the lost CanWest volume
4 at fixed prices.

5 **Q. Is the price change for the CanWest contract included in PSE's updated**
6 **power costs?**

7 A. No. As discussed by Ms. Ryan in her rebuttal testimony, Exhibit No. ____ (JMR-
8 12CT), the Company has not included the cost increase as the Commission has
9 not yet ruled on PSE's associated accounting petition.

10 **VII. LONG-TERM GAS PRICE FORECAST**

11 **Q. Please describe the purpose of this section of your testimony.**

12 A. This section of my testimony will respond to Mr. Schoenbeck's prefiled direct
13 testimony, Exhibit No. ____ (DWS-1T) at 17-18, to clarify how PSE uses the gas
14 price forecasts Mr. Schoenbeck references.

15 **Q. How does PSE use the types of long-term gas price forecasts shown in the**
16 **tables of Mr. Schoenbeck's testimony on pages 17 and 18?**

17 A. PSE's long-term planning and acquisition analysis processes, for both gas and
18 electric resources, attempt to accurately model the cost of various resources on an
19 annual basis over a 20-year planning horizon. For time periods beyond the first
20 24 months of these time horizons, PSE utilizes gas price forecasts from gas

1 market consultants based on fundamentals and modeled results. It is this type of
2 long-term gas price forecast that Mr. Schoenbeck proposes be used in lieu of
3 actual short-term market prices to estimate the Company's cost of gas during the
4 rate year.

5 However, the Company utilizes actual forward market prices rather than modeled
6 results to estimate the cost of gas during the first 24 months of such long-term
7 forecasts. As described more fully in Ms. Ryan's and Dr. Dubin's testimony, the
8 Company believes market-based prices, driven by actual buying and selling of
9 gas, is a reasonable estimation of short-term prices and one that has been accepted
10 by the Commission for a number of years as the basis of setting rates.

11 **Q. Do you have concerns with Mr. Schoenbeck's proposal to use an average gas**
12 **price for the period 2006-2011 to project power costs in this rate case?**

13 A. Yes. Taking an average of prices for these years artificially depresses the price
14 for the rate year because it includes years beyond the rate year. The time period
15 outside the rate year (any period after February 28, 2006) may have fundamentals
16 that are anticipated to be different than those in effect for the rate year. For some
17 time, long-term price forecasts have predicted lower prices in out years based on
18 anticipation that significant added capacity of imported liquefied natural gas
19 (LNG) will create a temporary dip in market gas prices. However, new potential
20 market fundamentals, even if they occur, are not expected to affect natural gas
21 market prices during the rate year.

22 In addition to Mr. Schoenbeck's gas prices not being related to the rate year, the

1 specific forecast his testimony references was published in October of 2003.

2 While an updated long-term forecast is not yet available, there are indications that
3 long-term gas prices (beyond the rate-year) will be significantly higher.

4 **VIII. CONCLUSION**

5 **Q. Please summarize your testimony.**

6 **A.** The following points summarize my rebuttal testimony in this proceeding:

7 i. PSE will require between \$ [REDACTED] million and \$ [REDACTED] million of external
8 capital during the rate year to fund its acquisition of new electric supply
9 resources, exclusive of impacts created by imputed debt from Purchased
10 Power Agreements.

11 ii. Mr. Schoenbeck's recommendation to remove \$2.6 million from PSE's
12 revenue requirement associated with outside consulting expense is an
13 inappropriate ratemaking adjustment and based on a mistaken assumptions
14 of the nature of the work performed by NCI—the Company's expense for
15 such activity is projected to be greater during 2005 than in the test year.

16 iii. The program to decommission and dispose of the White River
17 Hydroelectric Project is reasonable and the accounting treatment for
18 existing and future costs of such program proposed by Mr. Russell of Staff
19 is acceptable.

20 iv. Projected cost of coal for Colstrip Generating Units No. 1 and 2 and Units
21 No. 3 and 4 from cost-based coal supply agreements is determined in

1 accordance with their terms, not as a result of a change in coal mine or
2 project ownership.

3 v. The cost of gas under the CanWest Gas Supply Agreement during the rate
4 year has changed from the cost estimates first filed in direct testimony of
5 Ms. Ryan due to the anticipatory breach of such agreement by the supplier
6 and the subsequent negotiation of a settlement agreement with such
7 supplier.

8 vi. Mr. Schoenbeck's proposal to use a long-term gas price forecast to
9 estimate gas prices during the rate year is unreasonable and inappropriate.

10 **Q. Does that conclude your testimony?**

11 A. Yes, it does.

12 [DOCUMENT.01 / 07771-0089]