BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of	)	
	)	DOCKET NO. UE-990267
PUGET SOUND ENERGY, INC.	)	
	)	THIRD SUPPLEMENTAL ORDER
For (1) Approval of Proposed Sale of Puget Sound Energy, Inc.'s Share of the Colstrip Facilities, and (2) Authorization to Amortize Gain Over a Five-Year Period	)	APPROVING SALE; ORDERING DEFERRAL OF GAIN AND DEFERRAL OF POWER-COST CHANGES
. . . .	)	

SUMMARY

PROCEEDINGS: On March 4, 1999, Puget Sound Energy, Inc. ("PSE") filed an Application for an Order under Chapter 80.12 RCW authorizing the proposed sale of PSE's ownership interest in the Colstrip Generating Units 1, 2, 3, and 4 to PP&L Global, Inc., together with associated transmission assets. The Application also seeks authorization for a five-year amortization of any gain realized from the proposed sale. The Commission, in the Second Supplemental Order in this matter, conditionally approved treatment of PP&L Global, Inc.'s ownership of the facilities as an exempt wholesale generator ("EWG").

HEARINGS: The Commission held a prehearing conference in this matter beginning April 14, 1999, and continuing to April 28, 1999, and May 4, 1999. The Commission held a public hearing on July 15 and 16, 1999, before Chairwoman Marilyn Showalter, Commissioner Richard Hemstad, Commissioner William R. Gillis, and Administrative Law Judge Marjorie Schaer.

COMMISSION: The Commission authorizes PSE to sell its ownership interest in the Colstrip facilities to PP&L Global on condition that PSE defers the gain from the sale and from any power cost savings and passes those through to ratepayers in its next general-rate request proceeding. The Commission orders PSE to file a least-cost plan no later than December 31, 1999. The Commission orders PSE to file a general rate request no later than March 31, 2002.

PARTIES: Matthew R. Harris, Summit Law Group, Seattle, and Kimberly J. Harris, Perkins Coie, Bellevue, represent PSE; Simon ffitch, Assistant Attorney General, Seattle, and Robert F. Manifold, Special Assistant Attorney General, Seattle, appear as Public Counsel; Robert Cedarbaum, Assistant Attorney General, Olympia, represents the staff of the Washington Utilities and Transportation Commission ("Commission Staff"); Michael Brooks and Brad Van Cleve, Duncan Weinberg Genzer and Pembroke, Portland, represent the Industrial Customers of Northwest Utilities ("ICNU").

MEMORANDUM

PSE seeks three different orders from the Commission: (1) permission to sell its interest in the four Colstrip generation units to PP&L Global, Inc.; (2) an accounting order authorizing it to amortize the gain from the sale over five years; and (3) an order making necessary findings that will allow PP&L Global, Inc. to become an EWG.

In response to state electric restructuring legislation enacted in Montana, the Montana Power Company ("Montana Power") is divesting its generation assets, including its interests in the four Colstrip coal-fired generating units and associated transmission facilities. Other owners of the Colstrip facilities were invited to participate in the auction process, including PSE, which owns a 50% interest in Colstrip Units 1 and 2, a 25% interest in Colstrip Units 3 and 4, and a 36% interest in the 500 kV Colstrip transmission system.

PP&L Global, Inc. submitted the highest bid and subsequently negotiated a final sales agreement with PSE. The sales price for PSE's Colstrip investment is $556 million. This price would be reduced by $88.6 million if PSE's transmission is not sold to PP&L Global, Inc., and by $20 million if Portland General Electric's sale of its Colstrip interest is not approved by the Oregon Public Utilities Commission.

PSE will realize a gain from the sale of about $40 million, which would increase by another $10 million if PSE obtains a ruling from the Internal Revenue Service to permit pass-through of excess deferred taxes as part of the net gain. In addition, selling Colstrip will enable PSE to save about $140 million in power costs in the next few years. PSE proposes to amortize the gain from the sale over a five-year period which coincides, in part, with the Rate Plan that resulted from the merger that created the company. It also proposes to retain any power-cost savings during the Rate Plan period.

PSE identified three types of savings in its merger with Washington Natural Gas approved by the Commission 1997: "merger related" savings (i.e. efficiencies from eliminating duplicate functions); "best practices" (i.e. improvements in management efficiency for the new combined gas and electric utility); and savings associated with achieving "power stretch" goals (i.e. pursuing various ways to reduce the cost of PSE's power-supply contracts).

The primary question before the Commission is whether PSE's proposed Colstrip sale is consistent with the public interest. The answer to this question depends, in part, on the answer to a second question: Is PSE's proposed accounting treatment for this sale consistent with the public interest? The answer to this question in

turn depends on the degree to which the sale produces gains and power-cost savings, and how those benefits (or costs) are distributed.

APPLICABLE STATUTES AND RULES

A public service company may not sell a significant asset without prior authorization from the Commission. The following statutes and rules apply.

RCW 80.01.040 General powers and duties of commission. The utilities and transportation commission shall:

(3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, electrical companies, gas companies, irrigation companies, telecommunications companies, and water companies.

RCW 80.12.020 Order required to sell, merge, etc. No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its franchises, properties or facilities whatsoever, which are necessary or useful in the performance of its duties to the public, and no public service company shall, by any means whatsoever, directly or indirectly, merge or consolidate any of its franchises, properties or facilities with any other public service company, without having secured from the commission an order authorizing it so to do . . . .

WAC 480-143-120 Transfers of property. A public service company may not complete a transfer of property necessary or useful to perform its public duties unless the company first applies for, and obtains, commission approval. Transfers include sale, lease, assignment of all or part of a public service company's property, and merger or consolidation of a public service company's property with another public service company. . . .

WAC 480-143-170 Application in the public interest. If, upon the examination of any application and accompanying exhibits, or upon a hearing concerning the same, the commission finds the proposed transaction is not consistent with the public interest, it shall deny the application. [Note: this section was formerly WAC 480-143-150].

ISSUES PRESENTED

I. IS THE PROPOSED PROPERTY SALE CONSISTENT WITH THE PUBLIC INTEREST?

A. What Standards and Principles Should Be Used to Evaluate the Proposed Sale?

B. Is the Colstrip Sale Proposal Consistent With the Principles?

1. How Much Is the Gain on the Sale?

2. How Much Are the Power-Cost Savings?

3. Who Receives the Net Benefits, If Any, of the Sale?

C. How Should PSE Account for the Transfer?

II. HOW SHOULD OTHER ISSUES BE AFFECTED BY THE TRANSFER?

A. This Is Not a Stranded-Cost Proceeding

B. The Company Must Present a Business Case for Sales of Used and Useful Property

C. The Second Supplemental Order in this Matter, Approving the Exempt Wholesale Generator status of the Colstrip facilities, Should Be Affirmed

DISCUSSION

I. IS THE PROPOSED PROPERTY SALE CONSISTENT WITH THE PUBLIC INTEREST?

The first question presented is whether the Commission should approve the proposed property sale. If the answer is yes, then the Commission will need to decide how the company should account for the sale proceeds, and remove the condition from its order on EWG status. If the answer is no, then the other questions will not require resolution.

A. What Standards and Principles Should Be Used to Evaluate the Proposed Sale?

In order to approve the proposed sale, the Commission must determine that the sale is consistent with the public interest. As a first step in this analysis we must examine what constitutes the public interest.

In the merger of Puget Power and Washington Natural Gas[1], the Commission studied its authorizing statutes and recent federal policies to distill the following principles:

> Drawing on the statute cited above [RCW 80.28.074], and in consideration of the recently adopted FERC [Federal Energy Regulatory Commission] policy, we judge the public interest affected by the proposed merger using the following four standards.
>
> > 1. The transaction should not harm ratepayers by causing rates or risks to increase, or by causing service quality and reliability to decline, compared with what could reasonably be expected to have occurred in the absence of the transaction.
>
> This component of the standard considers the consequences of the transaction for those ratepayers directly served by the company(s) proposing the merger or property transfer.
>
> > 2. The transaction, with conditions required for its approval, should strike a balance between the interests of ratepayers, shareholders, and the broader public that is fair and that preserves affordable, efficient, reliable, and available service.
>
> This component of the standard considers the way interests are indirectly, as well as directly, affected by the transaction. The broader public in this component includes state policies concerning environmental, low income, and gas and electricity resource issues.

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[1] Fourteenth Supplemental Order, *In Re Merger of Puget Sound Power and Light and Washington Natural Gas* Docket. No. UE-960195 (February 5, 1997).

> 3. The transaction, with conditions required for its approval, should not distort or impair the development of competitive markets where such markets can effectively deliver affordable, efficient, reliable, and available service.

> Competition is entering the electric and natural gas industries, and its influence will likely continue to grow. However, competition is not, in itself, an enunciated state policy objective for utility service. Competition is an important tool, as is regulation, for accomplishing the policy objectives of affordable, efficient, reliable and available service. Consequently, a transaction's effects on competition must be considered not in isolation, but rather in light of the effect the transaction, and any conditions placed upon it, will have on these policy objectives.

> 4. The jurisdictional effect of the transaction should be consistent with the Commission's role and responsibility to protect the interests of Washington gas and electricity ratepayers.

> We are concerned that mergers and property transfers should not take place simply to accomplish a change in jurisdictional oversight for the companies involved. Any impact on the Commission's ability to continue to look out for the interests of Washington's ratepayers must be considered carefully.

Id. pp. 19-20.

In the recent property transfer application by PacifiCorp, the Commission articulated a standard of "no harm" to the public interest.

> The standard in our rule does not require the Applicants to show that ratepayers, or the public generally, will be made better off if the transaction is approved and goes forward. In our view, Applicants' initial burden is satisfied if they at least demonstrate no harm to the public interest. . . . We recognize from a review of these Orders that the approach for determining what is in the public interest varies with the form of the transaction and the attending circumstances.

Third Supplemental Order on Prehearing Conference, Docket No. UE-981627, *In Re PacifiCorp and Scottish Power PLC* (April 2, 1999), p. 3.

PSE asks the Commission to apply the four-part "merger standard" to evaluate this proposed property transfer. In the Company's view the Commission was clear that the standard should apply to all transfers, and the four factors are flexible enough to encompass this filing.

The Commission Staff replies that the merger order was established only to judge the merger, and does not, by its terms, apply to property transfers. The Commission Staff notes the language in the *PacifiCorp* order indicating that the test for determining the public interest varies with the form of the transaction and attending circumstances. The Commission Staff argues that the sale of the Colstrip facilities is a unique event which warrants a different approach as contemplated under the Commission's *PacifiCorp* test. The Commission Staff believes that a customer-benefits test should be applied because it is consistent with other public interest statutes (RCW 80.01.040(3)) and because the EWG determination requires a "benefits" test consistent with Staff's recommendation.

PSE replies that standards will cease to have any usefulness if the Commission uses a different standard for each proceeding. The Company notes that the Commission included a lengthy, detailed analysis of the public interest standard in the merger, rather than adopt Staff's proposed "consumer benefits" test. PSE's argues that its merger rate plan creates a different context for considering distribution of benefits, and that the EWG determination of benefits answers a different question than whether the Colstrip facilities should be sold.

Public Counsel asks the Commission to be guided by the four merger principles. In Public Counsel's view, only the first two criteria (the transaction should not harm ratepayers by causing rates or risks to increase, and it should strike a fair balance between ratepayers and shareholders) are relevant.

ICNU also analyzes the public interest issue using the four merger principles.

COMMISSION: Over time, and across different industries and transactions, different considerations may prove relevant to determining the public interest. Nevertheless, we find that in this specific case, all four of the principles enunciated in the PSE merger are appropriate in assessing the public interest. These principles are not minimum standards; rather they are guidelines that, when taken together, can be used to determine whether there is, at least, no harm to the public interest.

> 1. The transaction should not harm ratepayers by causing rates or risks to increase, or by causing service quality and reliability to decline, compared with what could reasonably be expected to have occurred in the absence of the transaction.

In the next section of the Order we will examine whether the transaction will harm ratepayers, and under what circumstances they might be harmed. We note that the appropriate comparison to be made in this analysis compares what is expected after the transaction to what one would expect in the absence of the transaction. This is a different comparison from that posed by PSE, which compares the benefits and burdens of the Colstrip facilities sale to the benefits and burdens of the Rate Plan. Also, as articulated in the next principle, the ratepayers' interests must be set in a broader context that also incorporates the interests of the shareholders and the general public.

> 2. The transaction, with conditions required for its approval, should strike a balance among the interests of ratepayers, shareholders, and the broader public that is fair and that preserves affordable, efficient, reliable, and available service.

The Commission will analyze the transaction and whether conditions are necessary for approval in order to ensure an appropriate balance of interests.

> 3. The transaction, with conditions required for its approval, should not distort or impair the development of competitive markets where such markets can effectively deliver affordable, efficient, reliable, and available service.

The Colstrip transaction is not one that could reasonably have been foreseen by the parties when the plants were first built and included in PSE's rate base. In the mid-1970s, it was not contemplated that PSE might choose to sell its generating assets, at least not without some plan in place for replacing them with other large, capital assets.

The Montana Power auction, as a result of Montana restructuring legislation, and the current Federal Energy Regulatory Commission ("FERC") policy of deregulating wholesale electric power, are new policies encouraging competition. The Commission seeks, too, to incorporate market influences in its regulation, where such markets can effectively deliver affordable, efficient, reliable, and available service. The decision of PSE management to diversify its portfolio, and to participate in the wholesale energy market must be considered in light of these developments, recognizing, however, that our legislature has not passed restructuring legislation.

4. The jurisdictional effect of the transaction should be consistent with the Commission's role and responsibility to protect the interests of Washington gas and electricity ratepayers.

This is a broad principle that helped inform our decision with respect to PSE's third request. In the Second Supplemental Order in this proceeding, conditionally approving EWG status for PP&L Global, Inc., the Commission has examined the jurisdictional effect of this transaction, and has determined that consumers and the public interests will benefit from operation of the Colstrip facilities as wholesale generation facilities not subject to state regulation.

B. Is the Colstrip Sale Proposal Consistent With the Principles?

PSE argues that its proposal to sell its Colstrip facilities meets the first three principles and that the fourth principle is not at issue here. In PSE's view, the benefit of the transaction is grounded in the Rate Plan included in the merger Stipulation. PSE reasons that ratepayers receive benefits from the merger rate plan in the form of rates lower than they otherwise would have been. PSE claims that under the merger plan, any benefits of the sale achieved during the rate plan period, which lasts until December 31, 2001, must flow to shareholders. Any benefits accruing after the rate plan are assigned by PSE to ratepayers. Thus, in PSE's view, the rate plan creates a balance of shareholder and customer interests.

The Commission Staff replies that the proposal fails both the first merger principle (because ratepayers will be harmed by the sale) and the second principle (because the accounting treatment sought by PSE is not balanced, in that benefits are tilted in favor of shareholder interests). The Staff concedes that there may be benefits, but argues that since the application fails to distribute more benefits than costs to ratepayers, it is not in the public interest. By Staff's analysis, the proposed accounting treatment, in conjunction with the merger rate plan, harms ratepayers by directing benefits of the sale to shareholders in the short term during the rate plan, and assigning ratepayers higher power costs in the longer term, after the rate plan expires.

Public Counsel also argues that PSE's plan for the sale of its Colstrip facilities fails the first two merger principles: it increases risks to ratepayers, and does not strike a fair balance between ratepayers and shareholders.

PSE's large ratepayers, ICNU, also argue that because ratepayers are exposed to the risk of higher long-term power costs, the accounting treatment falls short of even a "no harm" standard. The application does not meet the public interest standard and should be rejected as filed.

There are several ways of judging possible benefits of a sale. One is to study whether there will be a gain, and how much the gain will be. Another benefit (or risk) is the possibility of lower (or higher) power costs to replace Colstrip's energy, and the net effect of these through time. There may also be other benefits or costs.

1. How Much Is the Gain on the Sale?

Gain is the excess of the sale price over the net book value of the assets, and is reduced by the income tax effects of the sale.

PSE witness Mr. John Story calculates a net of tax gain of $37.6 million in his direct testimony. His rebuttal testimony recalculates two gains on sale: $40.0 million and $41.9 million. The first recalculation simply restates the gain for a period ending August 31, 1999, instead of the original date of July 31. This increases the gain as depreciation lowers the book value.

The second recalculation is in response to Commission Staff's proposal that environmental costs should be deferred, if they occur. Environmental costs are speculative and can be accounted for separately. Staff argues that environmental costs are appropriately removed from the gain calculation. The effect is to increase the gain by lowering a cost related to the sale. PSE agrees with the Staff proposal. The second recalculation also uses an August 31, 1999, ending date.

The calculation of the gain is an estimate and is subject to change. If the IRS rules in favor of the company's deferred excess tax treatment, the gain will increase about $10 million. In addition, if Portland General Electric does not obtain approval from the Oregon Public Utilities Commission to sell its interest in Colstrip, the expected gain will be reduced by approximately $20.6 million dollars.

Commission Staff witness Mr. Roland Martin calculates a gain of $39.4 million, using the period ending June 30, 1999, and assuming that environmental cost is excluded from the gain. The Commission Staff calculation is consistent with PSE's second recalculation save for the gain calculation period.

Since the amount of gain is estimated, and dependent on certain conditions being met, Public Counsel did not calculate a specific gain amount. Public Counsel is more concerned with disposition of the gain than with its specific calculation.

ICNU did not provide a separate calculation of the gain, but referenced Mr. Story's calculation from his rebuttal testimony. ICNU is also more concerned with disposition of the gain than with its specific calculation

Commission: The Commission agrees that the gain should be calculated without the environmental costs included because they are speculative and can be accounted for separately. The actual realized gain must also be calculated at the time of sale. Should the sale take place October 1, 1999, the gain must be recalculated for the period ended September 30, 1999. The Commission will use Mr. Story's rebuttal figure of $41.9 million as the best available estimate of PSE's gain from the sale for the period ended August 31, 1999. PSE should be required to provide the Commission with a new gain calculation at the time of sale.

2. How Much Are the Power Cost Savings?

Although PSE emphasizes the $40 million gain in its analysis, power-cost savings produce a considerably larger dollar impact of $140 million. All parties agree that there will be power-cost "savings" in the near term and "costs" in the longer term. However, this presents a moving target that depend on variables such as whether results are stated as a net present value (NPV) or in nominal dollars; what discount factor is used to calculate the NPV; what taxes are included in the calculation; what assumptions are used to estimate future power costs; and whether the gain on sale is included. It is difficult to determine which method and mix of variables will produce the most accurate picture.

PSE offered Exhibit 7, which shows several scenarios from a model predicting what gains and losses will accrue. The model measures power-cost changes out to the year 2018, and uses a 7.69% discount factor (except for scenarios 9 and 10). The company scenarios range from a <u>positive</u> (benefit to shareholders and ratepayers) NPV over 20 years of $478 million to a <u>negative</u> (detriment to shareholders and ratepayers) NPV over 20 years of $458 million. PSE provided, in response to Public Counsel data request PC-55 (Exhibit 15), scenarios reflecting recent Montana tax changes. The high and low ranges were not significantly different from the original Exhibit 7. The base case scenario, however, showed a reduced benefit from $23.8 million to $6.5 million.

The base case is the mid-range scenario provided by the company. The Commission Staff and Public Counsel examined this scenario, calculated with different underlying assumptions, to examine forecasts which were in line with their assumptions for the next 20 years. The company also provided modified versions of this scenario in its rebuttal presentation, and in responses to record requisitions.

In his rebuttal testimony, Mr. Story recalculated the base case from Exhibit 15 at an 11.83% discount factor under two scenarios: with and without a carbon tax of $10 per ton. (There currently is no carbon tax in place). These scenarios show a NPV benefit of $61 million and detriment of ($27 million), respectively. In response to Record Requisition No. 1 (Exhibit 20), the company ran the base case scenario using a

7.69% discount rate and including the effect of the known and measurable decrease in the Montana property taxes (a decrease that became law after the initial calculations). The effect of the Montana tax changes is a cumulative present value of positive $150 million with a carbon tax, and a cumulative present value of positive $3.6 million without a carbon tax. In each of these scenarios, PSE included the gain on sale in the model, which increases the NPV. Without the gain, the positive benefits would decrease and cause a negative detriment in the scenario with no carbon tax.

The company is proposing to replace a currently above-market resource with lower-priced resources. Exhibits 7 and 15 present various scenarios showing the benefits of replacing Colstrip with market resources. Even looking at the scenario from Exhibit 20 (PSE's response to Record Requisition 1, with no carbon tax) the sale produces significant near and intermediate term benefits.

Commission Staff witness Mr Kenneth Elgin restates the company's base case in nominal dollars to avoid the complexity and controversy resulting from selecting a discount rate. In his presentation, removing the discount factor makes the negative effect much greater: the cumulative total over 20 years is a negative ($201 million), including the gain on sale. Without the gain (i.e. just the power cost difference), the amount would be a negative ($259 million). Staff argues that most of the benefits of lower-cost power occur in the first five years when market power costs are projected to be significantly lower than the cost of Colstrip power. After the first five years, the cost to ratepayers could be substantial if the company were able to include in rates the increased market power costs that are expected to occur after 2004. PSE's customer rates are presently governed by a Rate Plan. With rates fixed by the Rate Plan through 2001, the majority of benefits of low-cost power would go to shareholders unless the benefits are deferred. In addition, Staff argues that the company has an incentive to avoid filing a rate case until market power costs increase over what Colstrip power would have cost, because the Company could retain the portion of power-cost savings projected to accrue after the end of the Rate Plan.

Commission Staff disagrees with PSE's proposal. Staff contends that ratepayers have funded Colstrip's significant capital costs in rates for 15 to 20 years. Shareholders have had a return on their investment through the authorized rate of return, and a return of their investment through depreciation. Staff concludes, therefore, that ratepayers should receive the benefits for the financial risks they have shouldered.

As Staff outlines these risks, PSE's full investment in Colstrip has been included in rate base. Ratepayers have been funding the significant capital costs which occur early in the life of the asset. It is likely that Colstrip will provide economic benefits after the facilities are fully depreciated. Finally, the risk of ownership has been borne by ratepayers in more ways than just the return of capital and reimbursement of operating costs. Ratepayers have also shouldered the significant risks, according to PSE, of the

company's minority interest in a distant coal-fired generating plant with the possible imposition of a carbon tax and future environmental remediation costs.

Public Counsel argues that the cost impact of the Colstrip facilities sale will be much more adverse than the company presents. Colstrip is expected to be a below-market resource by the year 2005. Public Counsel witness Mr. Jim Lazar ran the PSE model with several modified assumptions: (1) a lower discount rate of 7.16% (reflecting the company's current capital structure); (2) incorporating new, lower Montana property taxes; (3) adjusting the carrying costs of Colstrip to the company's current cost of debt; and (4) adding "end effects" (i.e. the value of Colstrip in 2018, at the end of PSE's analysis). The cumulative effect of these adjustments shows a "benefit" of negative of $20 million without the end effects, and negative $70 million with the end effects. Again, this analysis includes the effect of the gain. The negative benefits would be much greater if the gain were removed. Mr. Lazar provides a graph of the impact of power costs through the year 2018 which shows the value of power produced by Colstrip exceeding the cost of that power by approximately $260 million.

ICNU did not provide any independent calculation of the power-cost savings. ICNU analyzes this issue by looking at the market costs of power versus Colstrip's cost of power through the rate plan, exclusive of the gain on sale. The power-cost savings are approximately $62 million in nominal dollars. ICNU argues that this is an immediate reduction in power costs enjoyed by the company which should also benefit ratepayers.

Commission: The Commission will analyze the power costs and savings over the time period used by the parties. This time period matches the long-term lives of the Colstrip plants. The Commission, however, believes that using such a long-term forecast is subject to increasingly greater uncertainty about both the magnitude and direction of change. Thus, we have given more weight to the early term of these predictions, and we have not included an adjustment for end effects.

The best forecast model is provided by Mr. Story in Exhibit 20, which shows a $3.6 million net benefit from the sale. We would adjust this model as discussed below. Mr. Story originally adjusted Exhibit 7 consistent with Public Council's Data Request No. 55 (Exhibit 15) to reflect the Montana tax law changes. Subsequently Mr. Story, in his rebuttal testimony, ran the model at an 11.83% discount factor, and updated the model for plant decommissioning and depreciation true up (Exhibit 17).

Public Council, in Record Requisition 1 (Exhibit 20) asked Mr. Story to modify Exhibit 15 to reflect a 7.69% discount factor. Mr. Lazar recommends updating the discount rate to 7.16% to reflect the company's most current capital structure. The Commission agrees that this adjustment should be made. The Commission modifies Mr Story's Exhibit 20 to update the discount rate to the 7.16% recommended by Mr.

Lazar. Exhibit 20 already reflects the Montana tax law changes and no carbon tax. The result of our modification shows a $4 million net cost to the sale.

The discount factor used in the present value analysis represents the time value of money. The capital structure is the mix of debt and equity at a point in time. The discount factor represents the weighted cost of the debt for the capital structure at a specific point in time. The weighted cost of debt is less now than what was calculated in Puget's last rate case. It is appropriate to use the current discount factor based on the company's capital structure to approximate with some degree of accuracy the benefit or cost over time of either selling or keeping Colstrip. However, using the weighted cost of debt to estimate the carrying cost of an asset over time is less reliable. Whereas the weighted cost of capital changes in smaller increments over time, the actual interest cost over many years is more difficult to determine, enough so that the Commission will not include it as a variable in determining the net benefit of the sale of Colstrip.

We accept Mr. Lazar's recommendation of a 7.16% discount factor and the effect of the Montana tax law changes. We do not accept the end effects adjustment or the carrying cost calculation. Attachment A is a spreadsheet presentation of the adjustments approved by the Commission.

We note that both of these forecasts include the gain from the sale. Without including the gain, the best forecasts would show material losses. Considered in the context of a $556 million sale of assets, the range from positive $3 million to negative $4 million represents to us that the sale will approximately break even. This would be a neutral outcome if the sale is structured in a way that will not skew these results by imposing undue costs on one of the two groups (shareholders and ratepayers) who must bear the benefits/burdens of the sale.

3. Who Receives the Net Benefits, If Any, of the Sale?

PSE argues that its ratepayers are receiving benefits now as a result of the Rate Plan approved in its merger proceeding. The company argues it is proposing to replace a current above-market resource with lower market-priced resources. Exhibit 7 presents various scenarios showing the benefits of replacing Colstrip with market resources. Even under the worst-case scenario of Exhibit 20 (the version with no carbon tax) the sale produces significant near and intermediate term benefits.

PSE witness Mr. William Gaines also testified to certain qualitative benefits of the transaction, including: reducing risks associated with coal-fired generation and environmental liabilities; allowing PSE to take advantage of market prices and emerging technologies; and eliminating risks associated with owning a minority interest in a distant facility.

The Commission Staff responds that under PSE's proposal, the company will retain all the benefits of the sale. Exhibit 39 shows shareholders enjoying a $150 million gain through 2002 and $190 million through 2004. Ratepayers, on the other hand, incur a cost of $355 million after 2002 and $390 million after 2004. Ratepayers, Staff continues, are clearly harmed by this proposed accounting treatment. The heart of the company's presentation is a set of present-value scenarios designed to estimate the 20-year impact of the proposed sale on the cost of power supply. The company argues that these scenarios show there are power-supply savings from replacing Colstrip power with lower-cost purchased power.

Commission Staff witness Mr. Elgin agreed with PSE that there are qualitative benefits to the sale which will assist ratepayers. TR 263, ll. 18-20. Staff does not dispute PSE's qualitative benefits, but says they alone are insufficient to support approval unless the transaction produces quantitative benefits for ratepayers.

Public Counsel argues that there are no savings. The net benefits of the proposed sale are negligible, at best, and a large net detriment is more likely. Under the specific accounting treatment proposed by PSE, the company will keep all the benefits while PSE's ratepayers are harmed. Exhibit 20 (PSE's response to Record Requisition 1) shows a benefit to stockholders of approximately $76 million, and a liability to ratepayers of about $73 million, for a net benefit of $3 million. Public Counsel argues that this is a very small benefit compared to the $556 million PSE will receive for the sale of Colstrip, and a nominal value of Colstrip power of $3 billion.

ICNU also argues that PSE's proposal will give the company a majority of the gain and most of the power-cost savings during the remaining term of the Rate Plan. PSE's own analysis shows a net benefit to shareholders of $76 million and a net detriment to ratepayers of $73 million. Mr. Lazar shows a negative benefit to ratepayers of $80 million. Regardless of which analysis is more accurate, in ICNU's view the end result is the same: PSE's shareholders will derive all the benefit of the sale and power-cost savings while PSE's ratepayers will not derive any benefit from the sale and will be exposed to the long-term risk of higher future power costs.

The Commission agrees with PSE and Commission Staff that qualitative benefits could help ratepayers. While difficult to predict, it is possible that certain technological developments could make transmission of electricity generated from Colstrip expensive relative to alternatives. The distance of the Colstrip facilities from western Washington may emerge as a significant factor before 2018. But these potential benefits are speculative in nature and do not offset the proposal's more quantifiable costs to ratepayers.

Commission: As proposed by PSE, the Colstrip sale transaction would shift approximately $73 to $77 million in costs from shareholders to ratepayers. This is not an outcome consistent with the public interest, or with principles one and two in

particular. As proposed, the company should not be allowed to proceed with the sale, because its proposal shifts costs and risks to ratepayers, with no offsetting benefits.

C. How Should PSE Account for the Transfer?

PSE proposes amortizing the gain from the Colstrip sale transaction over five years, a period which coincides in part with the Company's merger-related Rate Plan (i.e. pre-programmed annual rate increases until December 31, 2001).

PSE argues that the proposed accounting treatment is consistent with the five-year merger Rate Plan. Under the Rate Plan, the company is exposed to risk by not being able to come in for rate relief unless it has an emergency need. In return for assuming this risk, the Company has an opportunity to manage its power costs, and retain any and all financial benefits it achieves during the five-year period. PSE argues that the Commission urged the Company to manage its costs aggressively, and expressly did not limit PSE to what had been identified as cost savings in the merger proceeding. The company also argues that the proposed sale does not fall within one of the specific exceptions identified in the Rate Plan. PSE apparently agrees that under normal conditions, the rule for a sale such as this is to pass all of the gain to ratepayers, because it makes this assumption for all gain amortized after the Rate Plan-period.

The Commission Staff argues that the Commission has consistently held that gains on sale of property held in rate base should be provided to ratepayers. The rationale for this principle is that ratepayers have returned investors' capital through depreciation rates, often accelerated in the early years of an investment. In Commission cases involving both depreciable and non-depreciable property, the Commission has ordered gains to be subject to deferred accounting until the next general rate request proceeding, then passed through to ratepayers.[2] Staff argues that PSE's proposal would go against Commission past practice in two significant ways: (1) shareholders would be guaranteed at least 60% of the benefits (more if the company did not file a rate case); and (2) since they would not be deferred to a rate case, these benefits would pass through to shareholders without any analysis of a need for an opportunity to earn increased revenues (single-issue ratemaking on behalf of shareholders).

The Commission Staff, Public Counsel and ICNU reply that sale of generating assets is not a merger-related "stretch goal" for PSE management. Public Counsel and Staff argue that cost-cutting measures were not intended to include selling

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[2] The Commission Staff relies on *Democratic Central Committee v. Washington Metro. Area Transit Comm.*, 485 F.2d 786 (D.C. Cir. 1973), and prior Commission orders.

generating and transmission assets, and that power stretch goals were intended to encompass renegotiation of PSE's high-cost purchased-power contracts. ICNU argues that nothing in the merger record supports PSE's interpretation of the Rate Plan or "power stretch" savings. There is no factual or legal basis in the Rate Plan for the accounting treatment proposed by PSE.

The Commission Staff alleges that ratepayers are clearly harmed by PSE's proposed accounting treatment. Ratepayers have shouldered the risks of the purchase of Colstrip in its early years and therefore deserve the benefits of the sale. According to Staff, if the application is approved, then the Commission should condition approval by ordering either open access or deferred accounting.

Under Staff's preferred option, <u>open access</u>, the Commission would require PSE to file tariffs with unbundled transmission and distribution services at the end of the Rate Plan, and to transfer its power supply portfolio to a sister company within PSE's newly formed utility holding company. This requirement would, Staff argues, be consistent with the merger, with PSE's new holding company structure, and with PSE's strategy of focusing on distribution services. This would allow shareholders to keep the gain on sale and power cost savings, and would resolve all issues related to stranded costs.[3]

Under the Commission Staff's <u>deferred accounting</u> option, Staff recommends that the Commission require deferred accounting of the gain on sale (which would accrue a return, compounded annually), and of power-cost savings, until the next rate case. Since the merger Order and Stipulation do not address sales such as Colstrip, applying principles previously embraced by the Commission and in the Court of Appeals stipulation ending the appeal of the order in Docket U-89-2688[4] (i.e. benefits should go to ratepayers, and be subject to deferred accounting) would be fair to ratepayers and not barred by the Merger Order. Deferred accounting would prevent a piecemeal approach to stranded costs, whereas PSE's accounting would consider Colstrip in isolation from the entire resource portfolio. In Staff's view, if PSE believes it is entitled to stranded-cost recovery, it is appropriate to defer all the benefits of the Colstrip sale to offset any potential stranded-cost liability.

Public Counsel contends that the company will keep all the benefits while PSE's ratepayers are harmed. It urges the Commission to reject the application. If the application is approved, ratepayers should receive all the benefits to offset future increased risks and costs. This may be accomplished by any of three options: (1) approve the sale and defer the gain and power-cost savings, accruing an appropriate

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[3] Stranded costs are further discussed *infra* pp. 19 - 21.

[4] Court of Appeals Docket No. 29404-1-I.

return, until the company's next general rate filing; (2) reject the application but allow the company to resubmit it as part of a comprehensive restructuring of its power-supply resources; or (3) pass all of the benefits through to ratepayers now by reducing rates effective January 1, 2000.

ICNU reasons that because the sale of Colstrip is not related to the merger, the gain should be deferred. Should the Commission approve the filing, the alternatives suggested by Commission Staff are both reasonable and required by the public interest standard.

PSE replies that accepting Staff's (or Public Counsel's) recommendations would violate the rule against single-issue rate making, i.e. fixing a rate based on an individual factor in the rate-making formula, rather than considering and weighing all relevant factors. Existing rate orders should be respected, since they are the product of the Commission's balancing of consumer and shareholder interests. Deferring the gains would preclude PSE from capturing any of the benefits during the rate plan period, and so would violate the rate plan, which reflected an "implicit balance struck by stipulating parties." The terms of the rate plan cannot be rewritten simply because PSE has found savings that Staff and Public Counsel now say were unanticipated.

PSE claims that Public Counsel's third recommendation (to order reduced rates beginning January 1, 2000) would explicitly violate the rule against single-issue ratemaking, since it would order reduced rates based on the Colstrip sale alone, without considering possible countervailing cost and revenue pressures on PSE.

Commission: In examining the first principle, the Commission must go beyond the gain from the sale to consider whether the proposed Colstrip sale transaction, compared to no transaction, harms ratepayers. As all of the parties have done, the Commission must consider the net of both the gain and the power-cost changes to determine whether the proposed sale transaction is consistent with this criterion.

The Colstrip sale proposal was not contemplated in the merger. Property sales were discussed in the merger, and PSE was to continue to follow the practice of deferring gains and losses of property sales until they could be passed through to ratepayers in the next general rate case proceeding. Certain property sales, of duplicate facilities due to the merger and credited to PSE's books as merger proceeds, were carved out as an exception to the general rule of deferring gains and losses. Any sales which the Commission Staff or Public Counsel objected to treating as merger savings were to be deferred to the next rate proceeding. The Commission in its order approving the merger did not grant PSE permission to sell used and useful generation assets as a power cost savings.

Perhaps most importantly, there do not appear to be net power-cost savings from the Colstrip sale transaction. To allow short-term savings to be allocated to shareholders, and longer-term losses to be allocated to ratepayers would be a material shift of benefits and burdens. If all of the gain from the sale, alone, were deferred and allocated to ratepayers, but all of the short-term savings from power costs were allocated to shareholders, then there would still be a material transfer of benefits from ratepayers to shareholders. Because the over-all transaction, including gain from the sale and power-cost savings, only breaks even, all gain and power-cost savings must be allocated to ratepayers to protect them from loss. Otherwise, the ratepayers lose, and there are no material offsetting benefits either to the ratepayers or to the public interest generally. Such an imbalance would violate our second principle, which strives for balancing the interests of ratepayers, shareholders, and the broader public.

Accordingly, all of the gain and near-term power-cost savings must be deferred, with a return, and allocated to ratepayers. If this is done, then PSE may sell its Colstrip facilities. In addition, the Commission should require PSE to actively pursue a letter ruling from the Internal Revenue Service allowing PSE to pass back to ratepayers the excess deferred taxes on the Colstrip facilities.

If the gain from the Colstrip sale clearly accrued benefits beyond the break-even point, then the Commission would need to determine whether or how to share those benefits between ratepayers and shareholders. That additional analysis is not made here, because no such benefits appear to be a probable result of the sale.[5] The public interest is broader than a mathematical calculation of costs and benefits. In each transaction brought before the Commission we will need to study the principles which will define consistency with the public interest, and apply those principles to the facts before us.

II. HOW SHOULD OTHER ISSUES BE AFFECTED BY THE TRANSFER?

A. This Is Not a Stranded-Cost Proceeding

Stranded costs arise when the costs of generation facilities and purchased power contracts exceed market valuation and the company cannot sell or otherwise recover the costs. The Commission has not found that stranded costs exist on any utility system it regulates. Commission Staff, Public Counsel and ICNU all suggest that allowing an individual sale of the Colstrip facilities, without offsetting benefits against possible future stranded costs, could mean that a future evaluation of PSE's generation portfolio would overstate stranded costs. If the Commission were to approve the accounting treatment of sales proceeds as proposed by PSE for this single

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[5] For this reason, this case does not require us to address or apply the theory of Democratic Central Committee.

transaction, then the company would accrue significant benefits. The parties point to PSE's annual report, which says that PSE has stranded cost exposure.

PSE argues emphatically that this is not a stranded-cost proceeding. It is simply an application for approval to sell its minority interest in a generation asset. The company has no stranded-cost issues and will not have any until there is a move to open access.

The Commission Staff argues that its preferred open-access option would resolve all issues related to stranded costs by transferring all of PSE's power supply to another company, and requiring PSE to compete in a competitive market for power. By the company's own admission, the sale of Colstrip was an opportunity to sell an above-market resource that raises potential stranded-cost issues, and the sale will "crystalize" stranded cost exposure. The company's approach takes each resource in isolation.

The Commission Staff indicates that its deferred accounting option would also resolve PSE's piecemeal approach to stranded costs. It would incorporate a portfolio approach to stranded-cost recovery, deferring power cost savings until the company's next general rate filing when all of PSE's resource costs can be considered together.

Public Counsel contends the sale is acceptable only if approval permanently resolves all stranded-cost issues for PSE. This could be accomplished by restructuring the company's power supply resources, and guaranteeing that ratepayers would not pay for any above-market power costs or stranded costs after the end of the Rate Plan.

For ICNU, the question of stranded costs and stranded benefits is a central issue in this proceeding. PSE's sale of Colstrip, the most significant generating asset it has on its books, creates a stranded benefit that should be netted against stranded costs. The record from the merger provides additional support for the idea that there is a relationship between the sale of Colstrip and the issue of stranded costs. The Rate Plan was intended to be a transitional step toward open access. PSE may seek stranded-cost recovery after the rate plan. In ICNU's view, if PSE is allowed to amortize the gain from Colstrip, it would not be able to be used to offset any future stranded costs the company may seek to recover. If PSE is allowed to keep the gains from the sale of below-market resources, yet charge ratepayers stranded costs for above-market resources, ratepayers will be harmed. Such a result, ICNU concludes, is not in the public interest.

Commission: The Commission will not convert this proceeding into a stranded-cost proceeding. The Commission accepts PSE's assertions that this sale is an opportunistic one, taking advantage of the Montana Power auction, and that the company does not, at present, plan to use its new corporate structure as a means to

restructure into a distribution company and a generation company. If PSE should choose to reshape itself as a distribution only company, our analysis of the current proposal allows the PSE management to make such choices regarding its generation resources, so long as that decision is consistent with the public interest.

The Commission decision should be construed narrowly. It stands for the proposition that, all else held constant, company management should be allowed to decide how the company's power will be acquired. It does not determine how any possible future stranded costs will be treated. Nor does it determine how any costs or benefits of future transactions should be shared. It simply allows PSE to go forward with the Colstrip facilities sale if it is structured in a way that will not harm the public interest.

B. The Company Must Present a Business Case for Sales of Used and Useful Property

The Commission's least-cost-planning rule (WAC 480-100-251) requires companies to forecast demand, evaluate ways to meet that demand, decide how it will meet demand at lowest cost, and prepare a two-year action plan to carry out its decision. PSE has not prepared a least-cost plan since 1992-93. PSE agreed to file a new plan as a result of the merger to account for its combined gas and electric operations, and has failed to do so.

PSE argues that integrated resource planning is an antiquated model for obtaining supply that assumes a vertically integrated utility meeting its needs through long-term supply contracts or construction of generation plant.

Public Counsel argues that PSE's failure to prepare and file a least-cost plan hampers PSE's ability to demonstrate how this sale will further its responsibility to meet load with a least-cost mix of resources. Although the Colstrip sale is opportunistic, not part of a plan, PSE cannot demonstrate how it will obtain power to replace Colstrip, let alone for its current resource needs, nor that it will do so at least cost. Public Counsel recommends the Commission consider issuing a complaint to hold PSE in violation of Commission rules for not completing a least-cost plan.

Commission: The Commission agrees that older models of integrated resource planning may be less useful analytical tools, given the emergence of wholesale power markets. However, the company continues to bear a "responsibility to meet its load with a least cost mix of generating resources and improvements in the efficient use of electricity." WAC 480-100-251(1). Although different kinds of power supply may be obtained, or shorter-term planning horizons may emerge, the Commission still considers it the responsibility of any utility to demonstrate what futures it sees as possible, and how it plans to meet its obligation to serve. The "new world" of

power supply will, in all likelihood, require more planning rather than less. Various market alternatives will need to be considered, with the sensitivity of each explored. PSE has not comported with these requirements. PSE should be ordered to file a Least Cost Plan no later than December 31, 1999. If PSE believes that any portions of the rule governing planning should not be applied, it may seek appropriate exemptions from the rule.

The facts that this sale is the result of an auction by a third party, and that independent analysts verified the fairness of the sale price, along with our conclusion that the sale will do no harm if the gain and short-term power cost savings are deferred, with a return, and passed through to ratepayers, allow the Commission to approve it. In addition, the Commission agrees with PSE and the Commission Staff that qualitative benefits will result.

But, as noted above, this is a narrow approval based on the circumstances arising in this case. In general, the burden of proof for outlining the business plan justifying the transaction, and for proving that no harm will occur, remains the burden of the company. In any future applications, we expect to see a least-cost-planning analysis.

In addition, the Commission should require PSE to file a general rate request no later than March 31, 2002. The test year should be calendar year 2001, in order to capture the new level of Bonneville Power Administration exchange benefits provided to PSE ratepayers.

C. The Second Supplemental Order in this matter, approving the Exempt Wholesale Generator status of the Colstrip Facilities Should Be Affirmed

The parties to this proceeding submitted a Stipulation and Draft order approving Exempt Wholesale Generator status of the Colstrip facilities post sale. The Stipulation would allow EWG status to go forward at the FERC, contingent on the ultimate finding here. The Commission entered such an order as its Second Supplemental Order in this proceeding.

The FERC requires the Commission to make certain determinations necessary for PP&L Global, Inc. to become an EWG, specifically, that EWG status: (1) will benefit consumers; (2) is in the public interest; and (3) does not violate state law.

PP&L Global, Inc. is an exempt public utility holding company under Section 3(1)(1) of PUHCA. In order to maintain its intrastate exemption, the PP&L Global, Inc. must obtain an order from FERC certifying Colstrip 1 as an EWG (15 U.S.C. 79z-5a(c)). If PP&L Global, Inc. does not obtain EWG status from FERC, it will not proceed with the purchase.

The Commission herein approves the PSE Colstrip sale proposal. The Commission confirms its earlier conditional findings that allowing the purchaser to become an EWG: (1) will benefit consumers; (2) is in the public interest; and (3) does not violate state law.

Having discussed above in detail the written testimony and the documentary evidence concerning all material matters, and having stated our findings of fact and conclusions of law in the text of the Order, the Commission now makes the following abridged summary of those comprehensive determinations. Those portions of the preceding detailed findings and conclusions pertaining to the Commission's ultimate findings and conclusions in this matter are incorporated by this reference.

FINDINGS OF FACT

1. Puget Sound Energy, Inc. ("PSE") is engaged in the business of furnishing electric and gas service within the state of Washington as a public service company.

2. PSE filed an Application on March 4, 1999, for an order under RCW Chapter 80.12 authorizing the sale of PSE's ownership interests in the Colstrip Generating Units 1, 2, 3, and 4, together with the associated transmission assets, to PP&L Global, Inc. The Application also seeks authorization for a five-year amortization of any gain realized from the proposed sale.

3. PSE owns a 50% interest in Colstrip Units 1 and 2, a 25% interest in Colstrip Units 3 and 4, and a 36% interest in the 500 kV Colstrip transmission system.

4. PSE will realize a gain from the sale of approximately $41.9 million. The gain will increase until the time the sale closes, due to the continued depreciation of the Colstrip facilities in PSE's rate base. PSE should be required to provide the Commission with a new gain calculation at the time of sale.

5. The gain from the sale will increase by approximately another $10 million if PSE obtains a favorable ruling from the Internal Revenue Service permitting pass-through of excess-deferred taxes as part of the net gain..

6. Selling Colstrip will enable PSE to save about $140 million in short-term power costs. In the larger term, there are expected to be higher power costs that approximately off-set the gain and short term power cost savings.

7. PSE proposes to amortize the gain from the sale over a five-year period which coincides, in part, with the Rate Plan that resulted from the merger that created the company. It also proposes to retain any power-cost savings during the

Rate Plan period. This proposal would shift approximately $73 to 77 million from ratepayers to shareholders.

8. PSE's proposal to amortize the sale over a five-year period, and to retain any power-cost savings during the Rate Plan period would harm ratepayers, and is not consistent with the public interest.

9. The best approximation of the cost/benefit of PSE's proposed sale of its Colstrip facilities shows a $4 million net cost to the sale.

10. If all of the gain and near-term power-cost savings are deferred, with a return, and allocated to customers, then PSE's sale of its Colstrip facilities will be consistent with the public interest.

11. The Commission determines that allowing PP&L Global, Inc. to purchase and operate the Colstrip Facilities as an EWG will benefit consumers and is in the public interest. Under these conditions, allowing the purchaser to operate the Colstrip Facilities as an EWG would not violate state law.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the parties and subject matter of the proceeding.

2. The PSE application to sell its Colstrip facilities and amortize the gain over five years is not consistent with the public interest, and is rejected.

3. PSE may sell its Colstrip facilities if it defers the gain from the sale, and all power-cost savings, with a return of 7.16%, and passes them through to ratepayers in its next general-rate-request proceeding.

4. The parties' Stipulation is approved. The Commission has made the necessary determinations under 15 U.S.C. § 79z-5a(c). The proposed transaction allowing the Colstrip Facilities to be a wholesale facility operated by an EWG: (1) will benefit consumers; (2) is in the public interest; and (3) does not violate state law.

ORDER

THE COMMISSION ORDERS:

1. The Commission authorizes PSE to sell its ownership interest in the Colstrip facilities to PP&L Global on condition that PSE defers the gain from the sale and from any power cost savings, with a return, and passes those through to ratepayers in its next general-rate-request proceeding.

2. The Commission orders PSE to file a least-cost plan no later than December 31, 1999.

3. The Commission orders PSE to file a general rate request no later than March 31, 2002.

4. PSE must recalculate the gain on the sale to match the date that the sale closes. That figure must be provided to the Commission.

5. PSE's application for a determination under 15 U.S.C. §79z-5a(c) is granted. The condition stated in our Second Supplemental Order has been satisfied.

6. PSE must seek a ruling from the Internal Revenue Service allowing pass-through of excess deferred taxes as part of the net gain from the instant sale.

7. The Commission retains jurisdiction over the subject matter and PSE to effectuate the provisions of this order.

DATED at Olympia, Washington, and effective this day of September, 1999.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION