

TABLE II
 THE WASHINGTON WATER POWER COMPANY
 Fair Rate of Return
 Washington Electric Operations

<u>Capital Component</u> <u>(A)</u>	<u>Capital Structure</u> <u>(B)</u>	<u>Cost Rate</u> <u>(C)</u>	<u>Weighted Cost Rate</u> <u>(D)</u>	<u>Cost of Capital</u> <u>(E)</u>
Debt	50.00%	9.82%	4.91%	
Stock	10.00	12.50	1.25	
Common	40.00	15.90	6.36	
TOTAL	<u>100.00%</u>			<u>12.52%</u>

WUTC
 DOCKET NO. UE-9916006
 EXHIBIT # 238
 ADMIT W/D REJECT

V. KETTLE FALLS PROJECT

The company, through a wholly-owned subsidiary, has constructed a 42 megawatt wood waste fuel steam plant near Kettle Falls, Washington (hereinafter referred to as the Kettle Falls project). This plant was placed in service in October 1983 and scheduled to be fully operational by January 1, 1984. The company has requested inclusion of its full allocated investment in rate base and the associated operating expenses. Commission staff and Counsel for the Public vigorously oppose the request. A brief chronology is set forth below.

- (1) In the late 1970's, the company perceived an energy short-fall, particularly for the period 1983-1988.
- (2) In 1977-1978, the company conducted feasibility studies evaluating the economic costs and availability of forest residue as a fuel supply for power generation. These studies concluded that energy from forest residue would be cost competitive with energy from coal and nuclear power, and that adequate wood waste fuel supplies were available.
- (3) From 1978 through 1980, the company conducted economic studies and budget projections for construction of a wood fired generating plant to be located near Kettle Falls, Washington.
- (4) In May 1980, the company performed a study to analyze the feasibility of the Kettle Falls project versus other resource alternatives. The alternatives considered included:
 - (a) The Kettle Falls project;
 - (b) Construction of a combustion turbine generating plant plus increased investment in the proposed Creston generating facility;
 - (c) Purchase firm power plus increased investment in Creston;

- (d) Construction of a combined cycle generating plant plus increased investment in Creston;
- (e) Construction of a combustion turbine generating plant with sufficient capacity to meet projected needs;
- (f) Construction of a combined cycle generating plant with sufficient capacity to meet projected needs.

(5) The study conducted in early 1980 was submitted to the company's board of directors in November 1980. After reviewing the proposed alternatives, the board of directors approved the Kettle Falls project.

(6) Due to financial conditions, the company did not begin construction in 1981.

(7) In December 1981, the company performed a second feasibility study which compared the Kettle Falls project to three alternatives:

- (a) Construction of a combustion turbine generating plant plus increased investment in Creston;
- (b) Construction of a combustion turbine generating plant plus use of power from the Washington Public Power Supply System's No. 3 nuclear plant when available;
- (c) Construction of a combustion turbine generating plant with sufficient capacity to meet projected needs.

(8) The December 1981 report was submitted to the company's board of directors in January 1982. The report noted that earlier fuel costs had been too optimistic, but recommended that the project be completed. The board of directors concurred.

Commission staff and Public Counsel take the position that the Kettle Falls project was not a prudent management decision because the company's feasibility studies understate the costs of the Kettle Falls project and overstate the costs of alternative sources of power. Commission staff and Public Counsel urge that the company's revenue request be reduced accordingly.

In this case, the focus is on a project which has been completed and will be in-service. To address whether or not such a project was prudently constructed requires three decisions: (1) was the initiation of the project prudent? (2) was the continued construction of the project prudent? and (3) were the construction expenses prudently incurred?

To test whether the initiation of the project was prudent, one would ask: what would a reasonable board of directors decide given the facts and circumstances known to them or which

reasonably should have been known to them at the time the decision was made.

To determine whether continued construction of the project after initiation was prudent and the expenses incurred in that continued construction were prudently incurred, one uses essentially the same test applied at a different point in time and necessarily premised on a reevaluation of the project.

As with all issues, the company bears the burden to prove initiation, construction and continuation of the project was prudent.

In 1980, the board of directors was presented with a cost study of the Kettle Falls project which compared the proposed project to several alternatives. None of the parties seriously contest the issue of need -- in 1980 it did appear and it was reasonable to conclude that a project approximately the size of Kettle Falls was needed in the near future to meet the company's forecasted load.

The parties criticized the cost study, pointing to alleged deficiencies and miscalculations. In particular, Commission staff faulted the 1980 study.

The Commission has carefully reviewed the evidence presented by all parties and their arguments concerning the 1980 study. The Commission has tried to place itself in the position of the company's board of directors. In 1980, there was a forecasted need for another source of power. Even accepting the alleged errors in the original cost study and making an adjustment for them, the Kettle Falls project was still the lowest cost means of meeting the forecasted need. In 1980 the national policy in energy (see, for example, the Public Utility Regulatory Policies Act of 1978 (PURPA)) encouraged the building of small scale generating facilities, particularly those using renewable resources; Kettle Falls was consistent with that policy.

The Commission is of the opinion that the decision to initiate the Kettle Falls project, even considering the alleged flaws in the cost study, was prudent. However, this is only the initial decision this Commission must make.

Simply because the decision to begin a project is prudent does not mean the continuation or completion of the project is ipso facto prudent. The Commission believes that a company must continually evaluate a project as it progresses to determine if the project continues to be prudent from both the need for the project and its impact on the company's ratepayers.

The company did conduct a review of the Kettle Falls project. The reevaluation was submitted to the board of directors in January of 1982. At that time the project was still forecasted as needed to meet the company's projected load. However, uncertainties in both the general economy and in utility load forecasts were apparent by that time. Further, the board should have been aware of regional forecasts of energy surplus.

The 1982 study showed that Kettle Falls was no longer the lowest cost alternative. In addition, wood waste, the source

of fuel for the project, was subject to competition from at least two sources, making fuel availability uncertain and its price level debatable.

The company apparently rejected the lowest cost alternative to Kettle Falls (combustion turbines) because of natural gas and oil fuel supply problems. However, the board should have been aware of fuel supply uncertainties for Kettle Falls as well.

Given the level of uncertainty in the economy, regional energy surplus, and uncertainties appearing in the availability and price of wood waste, the Commission cannot find that the company has carried its burden of proof that as of January of 1982 all aspects of completing the project were entirely prudent.

The question of what to do when a utility fails to demonstrate that completion of a project was in all respects a prudent decision is necessarily one which depends on the unique circumstances of each case. Ratepayers should not be forced to pay for all of the costs of a plant and thereby bear all risks when a company cannot demonstrate that its decision is not in all respects prudent. In this case, the Commission examined such things as the need for the project, the type, quality, and number of studies done prior to the initiation and during construction of the project, the degree of board scrutiny, the point in time on the construction timetable the continued construction cannot be demonstrated to be prudent, the overall cost and magnitude of the project, the relationship of sunk costs to estimated completion costs, the degree to which final project costs match estimated costs presented to the board, and the extent to which the project meets national and regional goals as expressed in legislation such as PURPA and in the Northwest Regional Plan.

The Commission is not holding that completion of Kettle Falls was imprudent. The Commission's decision is that considering all of the circumstances which existed in January of 1982 the decision to continue the project was not demonstrated by the company to be prudent in all respects and that the costs of that decision should not be borne totally by the ratepayer.

The challenging parties rely heavily upon the allegation that the company rejected a lower cost alternative presented to it in the 1982 reevaluation. The Commission agrees that any time a lower cost alternative can be found, the advisability of pursuing the project should be carefully weighed. Perhaps the company would have been better advised to more thoroughly explore the options presented to it. In fact, the Commission is of the opinion that the board should have requested and the company's staff should have presented a worst case scenario to the board both in 1980 and in 1982. Further, given the uncertainty in 1982, the board should have examined more critically the assumptions used in the 1982 study.

The facts in this case are that the lower cost alternative in 1982 was the combustion turbine proposal. The Commission is aware that: combustion turbines are usually considered peaking units not base load units; combustion turbines use a nonrenewable resource (oil or natural gas); the fuel price is subject to wide

price fluctuations; and use of such a unit certainly is not in line with the spirit of national policy expressed in legislation such as PURPA and the Fuel Use Act of 1978. Under these conditions, the Commission does not totally accept the criticisms advanced by the challenging parties.

In reaching its conclusion in this case, the Commission weighed the following factors:

- (1) The project was projected to be needed in both 1980 and 1982, projections which were not seriously contested;
- (2) The company did conduct studies both prior to the initiation of the project and while the project was underway;
- (3) The company studies were flawed, but not fatally so;
- (4) The company could have done a further study in light of the prevailing conditions in 1982, but did not;
- (5) The board of directors was reasonably involved in reviewing the project;
- (6) \$23,000,000 in sunk costs were incurred by January of 1982;
- (7) The project had a short (two year) construction timetable;
- (8) The project was a reasonable project in size and scope;
- (9) The expenses of the project as originally estimated appeared to be in and of themselves reasonable;
- (10) The board did not select a lower cost alternative (considering projected construction and operating costs) to Kettle Falls in January of 1982 and could have more rigorously studied the alternatives open to it;
- (11) Company staff could have prepared studies using different assumptions as well as preparing a worst case scenario both in 1980 and 1982;
- (12) The estimated systemwide cost of the project when originally approved was \$70,210,000; the completed project cost, \$77,830,400, excluding AFUDC.
- (13) The project does comport with the spirit of PURPA.

The 13 factors listed above are unique to this case. Additional factors may be considered in subsequent cases as dictated by the facts.

Considering all of these factors, the Commission finds the company must absorb a portion of the costs of the project. In determining an allocation of costs to be borne by the company and the ratepayers, the Commission considered several options, including but not limited to: disallowing a set percentage; disallowing of all costs incurred after January of 1982; disallowing AFUDC on the project; and disallowing the difference between the project and any lower cost alternative. The Commission is of the opinion that the ratepayers should pay only for the cost of the project as originally estimated. This cost is the basis for the initial decision found to be prudent by the Commission. The remaining costs shall be borne by the company. The effect of this decision is that \$80,555,706 of a total project cost of \$89,299,000 will be used to calculate the allocation between jurisdictions. Washington's portion of the company's plant in service is \$48,353,000.

VI. RATE BASE

Views of the company and Commission staff concerning the proper treatment for ratemaking purposes as to items of the company's plant in service or rate base are summarized in Table III.