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Item Number: 2A Mj

Docket: ~~UE-991498~~
Company Name: Puget Sound Energy

Staff: Merton Lott, Gas Industry Coordinator
Hank McIntosh, Regulatory Consultant, Energy
Roland Martin, Regulatory Consultant, Energy
Doug Kilpatrick, Electric Industry Coordinator

Recommendation:

Issue an order: a) approving the accounting and ratemaking treatment (as described below), in connection with Puget Sound Energy's purchase of a cogeneration project and, b) authorizing PSE to assume certain liabilities, pursuant to RCW 80.08.130, in connection with the purchase.

Discussion:

On September 29, 1999, Puget Sound Energy, Inc., ("PSE" or "the Company") filed a petition for an order regarding the accounting and ratemaking treatment in connection with PSE's purchase of a 160 megawatt natural gas-fired cogeneration plant from Encogen Northwest, L.P. (Encogen) near Bellingham, Washington. In addition, PSE seeks authorization pursuant to RCW 80.08.130 to assume certain liabilities in connection with the acquisition. According to the petition, the transaction is scheduled to close on or before November 1, 1999, and provides PSE with the opportunity to reduce the effective cost of purchases the Company is currently obligated to make under a power purchase agreement with Encogen. PSE estimates that these cost reductions will produce savings with a net present value of approximately $27 million in revenue requirement over the remaining 23-year useful life of the project. The Petition states that the order requested is necessary to enable the Company to enter into the transaction.

The petition also requests that, if the partnership being acquired remains a separate subsidiary of PSE, for ratemaking purposes the partnership be consolidated with PSE. PSE is purchasing the partnership that owns the project. It is PSE's desire to liquidate the assets and liabilities of the partnership into PSE. However, at the current time PSE is uncertain whether some factor such as federal income taxes may make the liquidation an imprudent action. Thus PSE needs an accounting order that would allow such consolidation for ratemaking.

In support of its proposal, PSE submitted an economic analysis comparing the cost of the existing power contract with the cost of the proposed acquisition. Because of the short time frame for review, Staff in its expedited review, placed substantial reliance on the Company's economic presentation to avoid potential delay of the transaction's closing. Based on its review, Staff generally agrees with PSE that acquisition of the project will significantly reduce the Company's power costs over the life of the project.

Premised on the principle that a sensible transaction producing an overall net benefit should not result in harm to the Company's earnings, Staff would agree with the company that PSE should be allowed to receive some share of the benefits created by the transaction during the remaining rate plan period, i.e., the next 26 months through December 31, 2001. However, Staff found that the distribution of the benefits between shareholders and rate payers resulting from PSE's original proposal was inequitable.

Subsequent to the Company's proposal, Staff worked with the company to achieve a cost recognition schedule that would produce an equitable sharing of benefits and meet needs identified by the Company. As a result, the Company proposed an amortization schedule which would accomplish these goals. A description of the revised proposal is provided below.

The Transaction and Proposed Accounting Treatment :

PSE proposes to purchase the Encogen facility for approximately $164 million. The acquisition costs include a cash payment of approximately $55 million, assumed debt of approximately $108 million, and approximately half a million in transaction costs. The company proposes to account for the purchase by debiting the Electric Production Plant account and crediting the associated Accumulated Depreciation with the amounts recorded in Encogen's books. As of November 1, 1999, the estimated gross production plant balance in Encogen's books is approximately $159 million and the accumulated depreciation is estimated to be $66.5 million for a net book value of $92.5 million. The remainder of the total acquisition cost, approximately $71 million, would be recorded in Electric Plant Acquisition Adjustments account.

In the revised proposal, PSE proposes to depreciate the net plant-in-service balance, $92.5 million, over the remaining useful life of the project, currently estimated at 23 years. This portion of the request is the same as originally proposed by PSE. Further, the Company proposes an amortization rate for the acquisition adjustment based on nine years at 11.1% annually. The amortization of the acquisition adjustment is different from the original proposal, which was based on 23 years. The Company's petition requests that all costs be recognized for ratemaking purposes in future electric rate proceedings.

Staff Analysis, Evaluation and Conclusion:

As stated above, Staff agrees with PSE that acquisition of the Encogen project will significantly reduce the Company's power costs over the life of the project. This determination is based on the presentation made by the Company and thus the decision to make the deal is the Company's responsibility to defend in future rate proceedings.

Based on the assumption that the transaction appears to be prudently entered into, Staff has concentrated on the issue of benefits to be shared between rate payers and shareholders. The original proposed accounting and ratemaking treatment produced results that greatly favored the shareholders. Viewed in the context of the operation of PSE's merger rate plan, PSE would have received approximately 64% (approximately $18 million) of the life-of-the-asset benefits on a net present value basis during the next 26 months. The remaining 36% (approximately $10 million) of the net present value benefits would accrue to the rate payers. Staff believes that the original proposal that was focused on enhanced near-term earnings was not in the public interest, and was inconsistent with the prior treatments accorded the Company in past power cost mitigation filings. Further, it needs to be pointed out that both the original proposal and the revised proposal result in a reshaping of the cost recovery; this item is discussed later in the memorandum.

Staff views the Company's acquisition of the Encogen project as an attempt to reduce the costs of the project over the life of the project. Review of the current contract and resulting cost recognition reveals that PSE would incur increasing costs, which are already substantially above market, until June 2008. Under its current contract, PSE has the option to purchase the plant for one dollar after June 2008. Following that PSE would incur only operation and maintenance expenses and some incremental capital expenditures through the remainder of the plant's useful life, an additional 14 years until 2022. PSE would then incur costs for the most part at or below anticipated market costs during that 14 year period.

Staff believes that it is appropriate to treat the cost savings as benefits accruing during a period of high costs, between now and June 2008. This does not imply that staff is opposed to reshaping of the cost recognition as discussed below, but only that for determination of how much benefit should flow to the company during the rate plan period, the high cost period is the appropriate one to review. In Staff's review, we have considered the Commission's order on Colstrip (Docket UE-990267), and also the decision related to PSE's buyout of the gas contract for the Tenaska contract (Docket UE-971619). In the Tenaska contract the Commission established an amortization rate for the up-front costs so as to ratably share the benefits of the buyout between PSE and the ratepayers. PSE's revised proposal, discussed below, also creates a ratable sharing of net benefits between the rate payers and shareholders.

Staff discussed its concerns with the Company and after consideration of the merits of Staff's arguments, PSE agreed to modify its proposal. Under the revised proposal, PSE will be authorized to establish an amortization rate based on a nine year life for the acquisition adjustment beginning November 1, 1999. The higher amortization rate decreases the rate-plan period benefits from approximately 64% of the total to approximately 29% or from $18 million to $8 million net present value revenue requirement decrease. Post rate-plan period net benefit are then increased from approximately $10 million to $20 million. Staff believes that with the revision, the potential inequity to rate payers is resolved, and both company and rate payers are afforded a fair sharing of the benefits of the transaction. Having resolved the inequity, the Company and Staff further agreed that parties in the next rate proceeding will not be precluded from proposing different treatments for the unamortized balances..

As indicated above both the original and revised proposals result in a reshaping of the recognition of costs for ratemaking. This reshaping results from the spreading of capital costs over the life of the project rather than paying virtually all capital costs during the original contract period ending June 2008. Staff believes that reshaping these costs is appropriate. The reshaping does not result in increasing remaining project costs in the year 2008 above the anticipated market costs for that period, and at the same time does help mitigate the above market costs being recognized presently and until June 2008. Further, staff believes that further reshaping of these costs should be considered in PSE's next general rate proceeding.

Recommendation:

Staff recommends the Commission order:

1. Approval is hereby given for the accounting treatment in the Company's revised petition as described in the body of this memo with respect to the Company's purchase of a cogeneration project from Encogen Northwest, L.P, (Owner) The Company is authorized to:

   (a) Include in Electric Plant Account 101 (Production Plant) the original cost of the project as recorded by the Owner;

   (b) Include in Account 108, "Accumulated Provision for Depreciation and Amortization of Electric Utility Plant," the accumulated depreciation recorded by the Owner;

   (c) Depreciate this net Electric Production Plant over the remaining useful life of the project, currently estimated to be 23 years;

   (d) Record as an acquisition adjustment in Account 114, "Accumulated Provision for Amortization of Electric Plant Acquisition Adjustments," the difference between the net book value of the project and the Acquisition Cost of the project;

   (e) Amortize this acquisition adjustment above the line in Account 406, "Amortization of Electric Plant Acquisition Adjustments," at a rate based on a nine year amortization commencing November 1, 1999;

   (f) Consolidate that partnership with the Company for rate-making purposes (if necessary where the Company owns the cogeneration project through a partnership).

2. The Company is authorized to assume the Loan Amounts, pursuant to RCW 80.08.130, in connection with its acquisition of the cogeneration project.

3. The Company's actions in purchasing the cogeneration project are subject to review in future rate proceedings. Any costs determined to be unreasonable or imprudent in such proceedings are subject to disallowance.

4. The Commission retains jurisdiction to effectuate the provisions of this order.