Agenda Date: January 29, 2003
Item Number: A1

Docket: UG-021584

Company Name: Avista Corporation d/b/a Avista Utilities

Staff: Mike Parvinen, Regulatory Analyst
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Recommendation:

Issue a complaint and order suspending the filing by Avista Corporation d/b/a Avista Utilities in Docket No. UG-021584 and set the matter for hearing.

Background:

On December 2, 2002, Avista Corporation, d/b/a Avista Utilities (Avista, the Company, or the utility) filed tariffs which, if effective, would extend Avista's Natural Gas Benchmark Mechanism for two more years, with some modifications. The current tariff expires March 31, 2003.

This tariff filing affects Avista's Tariff Schedule 163, which is Avista's "Natural Gas Benchmark Incentive Mechanism" (Mechanism). The Mechanism, in conjunction with Avista's Purchased Gas Cost tariff (PGA), determines the gas cost to be charged Avista's customers.

The Company is requesting that the Commission act on its filing by February 1, 2003. According to the Company, should the proposed tariff not become effective on April 1, 2003 as filed, Avista would have a 60-day transition period to transfer natural gas purchasing and management functions from Avista Energy back to Avista.

The Mechanism was first implemented in September 1999, in Docket No. UG-990614, for a period ending March 31, 2002. Even though the Staff pointed out conflicts with the Commission's policy statement the Commission allowed the tariff to go into effect as an experiment for the approximate three year period.

In Docket No. UG-011500, the Mechanism was modified, and a one year extension (through March 31, 2003) was approved.

Discussion:

A. Description of the Proposed Mechanism

Avista's tariff filing involves Avista's gas procurement strategy that is carried out with its affiliate, Avista Energy. The proposed Mechanism is fundamentally the same as the existing Mechanism. Avista proposes some minor modifications. For example, Avista proposes to extend the consideration of using storage in Tier 3 purchases (3% of the portfolio). And a more defined audit trail is proposed, to enable the Commission to verify gas supply contracts entered into to meet Avista's loads.

Otherwise, the proposed Mechanism maintains its three major components: the Commodity Component, the Jackson Prairie (JP) Storage Component, and the Capacity Release and Off-System Sales Component. Each Component is described in detail below:

Commodity Component:

Under the Commodity Component, gas volumes are purchased under a diversified portfolio approach intended to provide a balance of the lowest cost supply and price stability. The Commodity Component is based on a "tiered" approach, in which Avista's annual loads are separated into tiers. Tier 1 (about 50% of the portfolio) consists of volumes that would occur given any weather situation (baseload). Tier 1 is fixed price gas. 50% of the estimated annual load is hedged with a combination of fixed price supply contracts and storage gas under the JP synthetic schedule (the JP synthetic schedule is described later under the Storage Component of the mechanism).

Tier 2 (about 46.6% of the portfolio) consists of average volumes for each particular month based on historical data. Tier 2 is priced at a first of the month (FOM) index. For daily volumes that vary between the average and minimum of the range and the average and maximum range for Tier 2 (+/-10% of average), Avista Energy will be taking the risk for either the purchase of gas or sale of gas at first of the month prices.

Tier 3 (about 3% of the portfolio) consists of volumes above the average range. Tier 3 purchases occur, but infrequently and not for long periods of time. Tier 3 volumes are priced on the Gas Daily Index, or if it is economical to do so, gas is withdrawn from storage.

Tier 4 (about .4% of the portfolio) consists of peaking volumes. Peaking services are also required infrequently, and they are usually weather-driven. Peaking services are provided by either JP or the Plymouth Liquefied Natural Gas (LNG) facility, if economically feasible. Any withdrawals from JP storage will adjust the remaining synthetic schedule.

This "tiered" approach to gas supply acquisition is intended to provide customers with price stability through use of hedging purchases, as well as the benefits of market-priced gas. The Commodity Component is also intended to limit the amount of risk associated with daily load variations.

JP Storage Component:

The Jackson Prairie (JP) Storage Component is intended to provide additional savings from summer/winter price differentials as well as other operational benefits. Avista has developed a synthetic (predetermined) injection and withdrawal schedule based on historical injection and withdrawal cycles, modified to give customers the summer/winter differential based on 100% utilization of a full cycle. A "full cycle" is defined as injection until full and withdrawal until empty. Gas will be injected in the summer months when gas is typically cheaper, and withdrawn in the winter when gas is typically more expensive. The injection and withdrawal schedule also conforms to Northwest Pipeline Corporation's tariff provisions requiring the facility to be 35% full by June 30th, 80% full by August 31st, and 100% full by September 30th.

Storage can also be used in Tier 3 and 4, if it is economical to do so. The remaining synthetic schedule would then be adjusted based on volumes withdrawn to meet the Tier 3 or 4 needs.

Pipeline Capacity Release/Off-System Sales Component:

The Pipeline Capacity Release and Off-System Sales Component is intended to derive benefits from optimizing pipeline capacity reserved for the utility's customers. This

Component is designed to credit customers with 100% of the benefits of capacity release/off-system sales activity up to $5 million, and a 50/50 sharing between Avista's customers and Avista Energy above the $5 million level.

Alleged Benefits of the Mechanism to Avista's Customers:

According to Avista, its customers receive benefits from having Avista Energy manage the gas supply and capacity through Avista Energy's alleged economies of scale, market expertise, and absorption of various risks (credit, currency, nomination errors, entitlement, counter party, and intra-month price volatility within Tier 2 volumes). The Company estimates that without the Mechanism, Avista would incur an additional $4.6m in costs compared to the current cost of $900k ($.05 adder times 17,600,000 estimated annual volumes). Staff has concerns with this analysis, as detailed later in this memorandum.

B. Application of the Commission's Policies on Approval of Management Decisions

The proposed tariff is unusual in that it embodies a management decision on a gas purchasing strategy. Staff is concerned that allowing the proposed tariff to go into effect is tantamount to preapproval of that management strategy for gas purchases. Once the tariff is in place, the Commission may be able to effectuate changes only prospectively. Allowing this tariff to go into effect would seriously impair Staff's ability to raise the prudence of the gas purchasing strategy embodied by this tariff when Avista proposes to recover amounts deferred under this strategy in its Purchased Gas Adjustment. Staff sees no compelling reason that the proposed gas purchasing strategy requires a tariff. As noted in point F below, Avista management would be able to continue the purchasing strategy embodied by this tariff without the tariff.

C. Application of the Commission's Policies on Affiliated Interest Transactions

The Commission may disapprove a Company's contract or arrangement with an affiliated interest if the Company failed to prove that the contract or arrangement is reasonable and in the public interest. RCW 80.16.020. Historically, the commission has priced affiliated interest transactions at the lower of cost or market.

Since Avista's actual gas costs under the proposed tariff come from Avista Energy (the subsidiary), two questions arise: "What is the market price of the gas purchase

arrangement between Avista Utilities and Avista Energy?" and "What are Avista Energy's actual gas costs to serve the utility?" The first question is addressed in section E of this memo, which explains that the Company has not provided the market price of the total proposed gas purchasing arrangement. The following addresses the second question.

One of Staff's major concerns with the original mechanism approved in Docket No. UG-990614 was that there was no way to audit and determine what Avista Energy was paying for the gas to serve the utility. Despite Avista's attempts to address this problem, it still persists. For example, the Company has developed the Tier approach, with Tier 1 being hedged contracts that are specifically entered into for the utility. Tier 2 costs are based on first of the month index prices. Avista Energy will enter into contracts at first of the month prices to cover average monthly volumes under Tier 2 for the utility. These two tiers cover gas costs that are directly paid by the utility, and cover approximately 85% of the utility's annual loads.

While Staff can verify that Avista Energy did enter into contracts that *could* serve the utility's monthly loads, these contracts are only representative of the costs Avista Energy incurs to serve the utility. Because Avista Energy operates on a total portfolio basis, all gas available on any given day at the individual basins is compared to projected volume requirements at each of the basins, and daily transactions are entered into to balance system loads and make as much profit as possible by "playing" the differentials between prices at each basin. Notwithstanding the Company's efforts to provide a method to verify Avista Utilities' costs, Staff still cannot verify that portion of Avista Energy's costs which actually *do* serve the utility under the proposed mechanism.

D. Application of the Commission's Policies for Evaluating Purchased Gas Adjustment Mechanisms

Overview.

In Docket Nos. UG-940778 and UG-970001, the Commission issued a Policy Statement in which guiding principles for evaluating purchased gas adjustment mechanisms were established. Attached is a copy of that Policy Statement.

The Commission's Policy Statement applies to Avista, and all other Local Distribution Companies (LDC), and it was issued to provide guidance for the implementation of gas purchasing incentive mechanisms.

The Mechanism proposed by Avista is not consistent with the most primary guidelines within the Commission policy. It is an affiliated interest arrangement where the affiliate Avista Energy, and not Avista, has the incentive to beat the benchmarks or prices charged to Avista. The only aspect of the Mechanism that constitutes an incentive for Avista is the 50/50 sharing feature of the Capacity Release/Off-system Sales Component. However, even under this feature, Avista Energy takes zero risk.

Application of the Commission's Policy Statement to Avista's Proposed Mechanism.

In its Policy Statement, the Commission adopted 15 guiding principles to apply in the evaluation of purchased gas incentive mechanisms. The guiding principles that present major concerns in Avista's filing are discussed here.

Guiding Principle Number 1. Under this Principle, the appropriate incentive mechanisms "reward companies based on performance relative to an external benchmark of market gas cost." The Mechanism Avista proposes is a gas acquisition strategy in that the costs charged to customers are based on external benchmarks (market costs). It does not compare Avista's performance to external benchmarks. Originally, the benchmarks and commodity adder were established based on how Avista actually performed compared to the benchmarks or market costs at that time. How Avista would operate today as compared to the benchmarks established four years ago is difficult to say. There have been many changes to the industry. Costs by basin have changed. Customer usage has changed. Commodity contract valuing has changed. Risk components have changed. Value of capacity has changed. Ability to acquire and sell gas in the markets has changed.

Avista's costs could be much different, possibly even lower than those charged by Avista Energy. An example of how costs would be different is that Avista may be inclined to purchase more fixed price (Tier 1) gas from the Rockies basin (currently the lowest price basin) and release the corresponding capacity from the other basins. Gas costs would be less and capacity release revenues would either be higher or lower depending upon the value of the capacity from the other basins.

Guiding Principle Number 4. Under this Principle, "the gas commodity portion of incentive mechanisms should judge performance against a benchmark for gas costs based on market prices, not an LDC's historic gas costs. Using an external benchmark for the commodity portion will provide LDCs with the incentive to perform better in the market."

In Avista's original Mechanism, performance could not be measured against external benchmarks, because Avista Energy's costs could not be determined. However, the external benchmarks were used for pricing, with savings from historical performances against the benchmarks built in as a guaranteed benefit. This was done in the form of a reduced "adder" and other guaranteed benefits. The historical adder was greater than $.05, but $.05 was used for pricing, to give customers a level of pricing better than what the utility had achieved in the past, compared to the historical benchmark calculations. The Mechanism contains no incentives based on a comparison of actual costs to a benchmark. The adder now is more of a payment made to Avista Energy for accepting risks inherent with the gas procurement business.

Guiding Principle Number 5. Under this Principle, "revenue and risk sharing should be symmetrized between the company and ratepayers, *i.e.*, incentive proposals should incorporate a risk of loss of poor performance as well as opportunities for rewards for good performance."

There is no revenue and risk sharing symmetry in Avista's proposed Mechanism, with the exception of a 50/50 sharing beyond $5m in capacity release/off-system sales revenues. However, with capacity release/off-system sales, Avista Energy is at zero risk. Avista Energy cannot lose anything – it only shares in gains if the $5m benchmark is achieved. Customers are 100% responsible for all losses and gains up to the $5m benchmark.

Avista Energy purports to take on all the risks associated with daily variations around the average load in Tier 2. This may or may not actually amount to any risk. Avista Energy takes on all the risks and gains all of the rewards associated with the daily operations of managing its overall gas supply portfolio. This is the area where there is potential for Avista Energy to benefit from managing the utility's supply and capacity. Avista Energy has stated that it would not be willing to take on these risks for only $.05 per decatherm (approximately $900k annually), if it were not for the value added by

increasing Avista Energy's presence in the market, by having access to additional capacity and additional opportunities to participate in the markets.

There is no risk or reward at all to Avista Energy in the Mechanism with regards to storage. There is a synthetic schedule which Avista Energy follows to the letter (with the exception of Tier 3 and 4, which only adjusts the remaining synthetic schedule, still creating no risk for Avista Energy). The way the Mechanism is designed, there is risk assigned to Avista Energy only if it chose to deviate from the synthetic schedule. For example, if Avista Energy chose to inject more gas into storage than the synthetic schedule allowed, that would put Avista Energy into a "long" position, with gas priced at a level other than that which is used in the Mechanism, because withdrawal prices are based on the synthetic schedule. The same would occur if Avista Energy took too much gas out of storage as compared to the synthetic schedule. In that situation, Avista Energy would be in a "short" position and it would have to cover that position in the future at an unknown price. There are risks associated with these unknown future prices, but historically, Avista Energy has not been willing to take those risks and by following the synthetic schedule Avista Energy avoids all risks.

Accordingly, the proposed Mechanism does not provide symmetry around the sharing of risks and rewards.

Guiding Principle Number 6. Principle Number 6 addresses the use of "dead bands": "Dead bands around the total cost benchmark may be useful to dampen random market effects. If a company's incentive proposal incorporates a dead band, then it must apply to both losses and gains."

Dead bands can also have the effect of building in a level of incentive or guarantees for customers. However, there are no dead bands in the proposed mechanism. The only things resembling a dead band in Avista's proposed Mechanism is the $5m trigger in the Capacity Release/Off-System Sales Component. But that band does not apply equally to losses and gains. Customers are responsible for 100% of the losses and gains up to $5m, they share all gains beyond $5m, 50/50.

A proper dead band around capacity release/off-system sales revenues would resemble a starting value, guaranteed to customers, based on historical levels (in this case approximately $5m) and Avista Energy would accept the risks above and below the

starting value by a range of say $1m. Anything above or below the dead band would then be shared symmetrically.

E. The Benefits to Avista of the Proposed Mechanism are not Significant

The Company claims that it would cost customers approximately $4.6m to bring the gas purchasing and management functions back under the utility as opposed to the current $900k "adder" which Avista pays to its affiliate, Avista Energy. Staff disagrees with Avista's calculation of the $4.6m.

Included in the calculation of the $4.6m is $1.4m for price volatility associated with volume variations in Tier 2. The $1.4 comes from a response to an Avista Request For Proposal (RFP), and it covers Tier 2 services only. It therefore fails to take into account the benefits of managing a total portfolio. In the normal course of business, the use of the total portfolio approach would reduce this cost dramatically, eliminate it altogether, or possibly create net benefits.

Under the Mechanism, Avista Energy accepts the risk of buying or selling gas on the daily market to meet the +/-10% variation around the average projected volumes. This means that if Avista's daily gas volume is greater that the average, Avista Energy will have to buy the extra gas on the daily market. The theory is that if Avista Energy needs to buy gas in that situation, it must be colder than normal, and the price would therefore be higher than the First of the Month (FOM) index price. On the other side, if Avista's gas volumes are below average, then it must be warmer than normal, and the daily gas price would be below the FOM index price, and therefore, Avista Energy is selling gas into the daily market at a price less than Avista Energy is paying for that gas.

These assumptions may or may not be true in actual operations. Daily price varies within the month, but it is not necessarily related totally to weather. Other conditions affect the ultimate price of gas, such as basin price differentials, and the possible use of storage.

Also included in the $4.6m is $512,500 for "credit risk." This item should also be removed from the calculation. Credit risk may be higher for Avista now than it was when the Mechanism first went into place, but the credit required to operate in the market is due to Avista Corp.'s credit rating. These costs would not necessarily be absorbed by the rate payers.

Another item included in the $4.6m is $2m for a calculation of loss of benefits for capacity release/off-system sales transactions that Avista Utilities would have to absorb if Avista Energy was not managing the capacity. It is true that Avista Energy has a greater presence in the market than the utility would have, but the $2m calculation includes a highly extraordinary period during the "Energy Crisis" (November 2000) where Avista Energy was selling as much gas as possible to the Malin basin at an exorbitant price. Avista customers did get 90% of the benefits of those transactions through the original mechanism, which resulted in approximately $6m. But if an adjustment is made to reflect normal activity over the previous three year period the Mechanism has been in place, the $2m would be adjusted to approximately $500k. This does not include the fact that the utility's capacity release/off-system sales were increasing at the time the Mechanism began, and the level of capacity release/off-system sales by Avista Energy has been decreasing each year.

Taking into account the three items discussed above, the $4.6m of additional costs the utility would incur if the mechanism were transferred back to the utility would realistically be more in the range of $1.3m. This $1.3m would also be reduced by the benefits to Avista of being able to control gas supply purchases by basin in order to mitigate overall price. This $1.3 million would be compared to the $900k that Avista Utilities would pay with the $.05 per decatherm adder contained in the proposed Mechanism; a difference of only $400k, before the benefits from basin management are considered.

F. Alternatives to the Proposed Mechanism

In the event the Commission does not allow the proposed tariff to go into effect, Avista Utilities management has the discretion to allow the proposed mechanism to continue as an affiliated interest transaction, or to move the gas purchase function back to the utility. Avista Utilities has not provided data to staff which shows clear benefits to the utility from the affiliated interest transaction. Staff would continue to find it extremely difficult to price transactions between Avista Utilities and Avista Energy at the lower of cost or market, consistent with the Commission's policy on affiliated interest transactions. However, a Commission decision to suspend the proposed tariff is not a decision on how Avista should manage its gas purchases. Should the Commission suspend the tariff or not approve the Mechanism and Avista Energy continues to provide the gas procurement function as an affiliated transaction, then Avista would

bear the burden of demonstrating that the costs paid to Avista Energy are at the lower of cost or market. This demonstration would most likely take place in the Company's next Deferral Amortization filing where the costs to Avista Energy would be included for rate recovery.

Summary:

Avista's proposed Mechanism is not consistent with the Commission's Policy Statement on Purchased Gas Adjustment Mechanisms. It should not be allowed to go into effect.

If the tariff does not go into effect, and Avista wishes to continue with its procurement strategy, it may do so, not by means of the tariff it filed, but by simply continuing its affiliate arrangement with Avista Energy. However, that affiliated transaction can and will be reviewed in the context of a gas cost recovery filing (deferral amortization filing), and appropriate adjustments made, if necessary. The burden will be on Avista to prove the propriety of those transactions.

If the tariff goes into effect, the Commission's ability to review the underlying transactions may be severely limited. That is because the tariff itself essentially "codifies" Avista's gas procurement strategy in tariff form. So long as Avista follows the terms of the tariff, the underlying transactions can effectively be insulated from Commission review. Only prospective changes could be made, through a complaint against the tariff. This has the same effect as pre-approving Avista's gas procurement decision. That is not appropriate.

Conclusion:

Avista's tariff filing in Docket No. UG-021584 should be suspended and set for hearing.

Attachment