AVISTA COMMENTS ON DECOUPLING
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I. INTRODUCTION

Avista appreciates this opportunity to file written comments regarding the Commission's Rulemaking to Review Natural Gas Decoupling. Avista believes that some form of decoupling is appropriate and consistent with state and regional energy efficiency objectives, and the ratemaking objectives of providing for the recovery of the fixed costs associated with providing energy service to customers.

In these comments, Avista will first address the background and/or context for consideration of a decoupling mechanism. This context includes, among other things, the reasons for considering a decoupling mechanism, the principles that should form the foundation of a successful and effective decoupling mechanism, the challenges in developing such a mechanism, and proposed solutions to those challenges.

Avista will also address the specific topics identified in the Commission's "Notice of Opportunity to File Written Comments" issued May 16, 2005, including comments on Cascade's decoupling proposal, and Northwest Natural's current mechanisms. Avista will also outline an alternative decoupling proposal for the Commission's consideration.

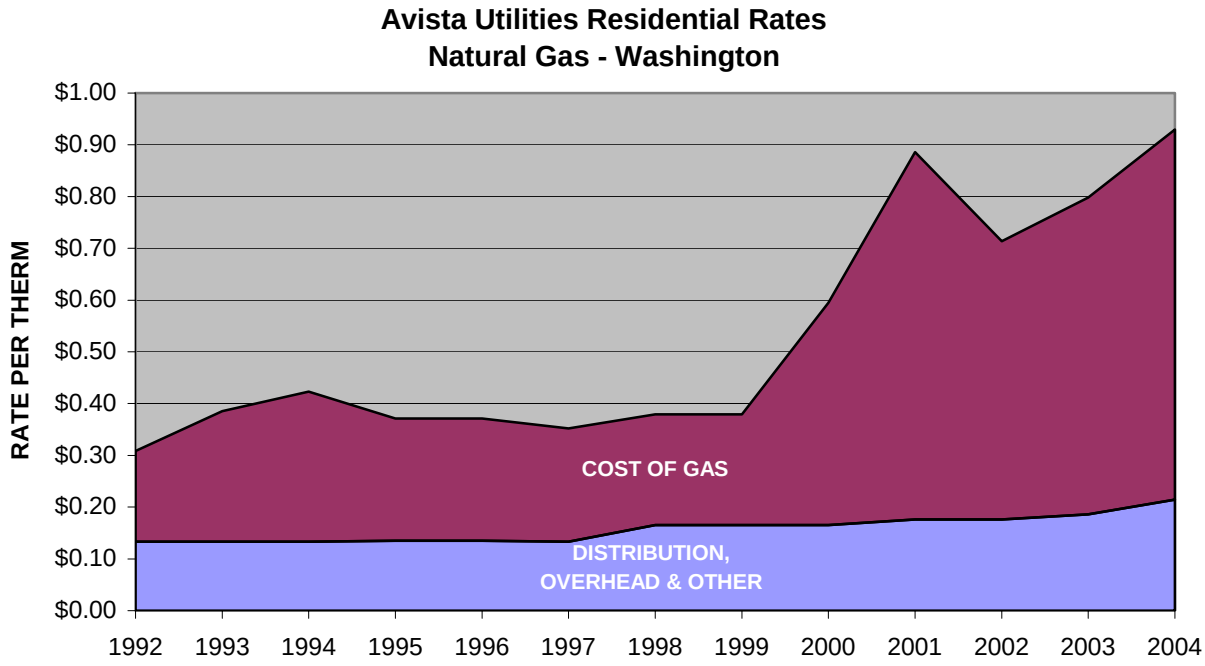
II. CONTEXT

A. Reasons for a Decoupling Mechanism

Consistency with State and Regional Energy Efficiency Objectives

The current high prices for natural gas, and an expectation that high prices will continue for the indefinite future, make consideration of some form of decoupling especially important at this time. The following chart illustrates the changes in the cost of natural gas since 1992. The

bottom portion of the graph shows the change in the Company's non-gas costs (margin rates) over time. The upper portion shows the dramatic increase in the cost of natural gas in recent years.



These high natural gas prices make it increasingly important to focus on effective energy efficiency measures. But because current ratemaking structures provide recovery of the majority of a local distribution company's (LDC) fixed costs based on a per-therm rate (sales volume), energy efficiency objectives are directly at odds with the opportunity to recover the fixed costs of providing service to customers. Decoupling would break the link between the volume of therm sales and recovery of fixed costs and would provide for an increased focus on energy efficiency. Increased energy efficiency would not only benefit the individual customers participating in the energy efficiency measures (through reduced bills), but would also reduce the overall demand for natural gas in the industry, which would result in downward pressure on natural gas prices for all customers.

Avista has had a natural gas DSM tariff rider and programs in place since the mid-1990's and has worked closely with other stakeholders on DSM policy and programs. Although Avista has been among the leaders in the Northwest in implementing and supporting DSM programs, an effective decoupling mechanism would lead to even greater natural gas energy efficiency efforts by Avista and other LDCs.

Consistency with Rate Making Objectives

As noted earlier, in the ratemaking process, the recovery of the majority of an LDC's fixed costs to serve customers is based on a rate per therm for each therm sold. Ideally, the fixed costs of providing service would be recovered on a per customer basis each month since the facilities and support services must be available to serve customers each month irrespective of how much energy they use. Avista has a monthly residential customer "basic charge" of $5.50 per month, and the remainder of Avista's fixed costs for residential customers is recovered on a per therm basis. Avista's total non-gas fixed cost (margin rate) for residential customers is approximately $20 per month[1] as compared to the $5.50 basic charge.

The current ratemaking structure is used, at least in part, to balance competing objectives. A primary ratemaking principle is "cost causation," i.e., customers that cause the costs should pay the costs. This principle would suggest that customers should pay their share of the fixed costs to serve them, irrespective of the amount of energy they use. A competing objective in ratemaking, however, is sensitivity to the impact of various rate structures on customer groups. Concerns have been raised in the past that the monthly energy bill impact from a significantly higher "basic charge" may be too burdensome for limited income households.

Irrespective of the rate structure chosen, the base rates established in a rate proceeding are designed to provide full recovery of the fixed costs to provide service to customers. When

[1] Based on a margin rate of $0.194/therm and an average use per customer per month of 75 therms plus the $5.50 basic charge.

fixed costs are recovered through sales volumes and sales volumes are lower than expected, then the intended outcome or ratemaking objective, to provide recovery of fixed costs, is not accomplished. Some of the primary reasons for actual sales volumes being lower than expected are implementation of energy efficiency measures, price elasticity (reduced usage due to higher prices), and warmer temperatures (weather). An effective decoupling mechanism, which separates the recovery of fixed costs from sales volumes, is consistent with the ratemaking objective of providing recovery of the fixed costs of providing service to customers. Decoupling could be implemented without altering the existing rate structures.

Since 1998, the Company's Washington residential and small commercial gas customers have reduced their average usage by over 12%. During the past several years, Avista has had general rate increases in all three states where it serves natural gas. A primary cause of these increases was the substantial reduction in customer usage that led to an under-recovery of fixed costs (margin). Had a decoupling mechanism been in place during this time, these general rate increases would have been significantly lower, and customers would have instead seen smaller annual rate changes reflective of the annual reduction in customer usage. Smaller annual rate changes are generally more manageable by customers than larger, less frequent ones.

B. Avista's Underlying Principles for an Effective Decoupling Mechanism

1) Keep it as simple as possible

2) Achieve target objectives

- remove disincentive for increased energy efficiency

- provide recovery of fixed costs

3) Provide for review of the mechanism and results

The two primary factors affecting customer gas usage and the Company's recovery of fixed costs are the variability in usage caused by abnormal weather and the reduction in usage caused by price elasticity and/or conservation. A decoupling mechanism should incorporate an adjustment for abnormal weather, as well as price elasticity/conservation, to provide the utility a reasonable opportunity to recover fixed costs. Additionally, a decoupling mechanism that includes an adjustment for abnormal weather results in a simpler mechanism that avoids the complexities of trying to separate the effects of weather and price elasticity/conservation. The utility can simply compare actual customer usage for a given period to the weather-normalized usage approved by the Commission to determine the adjustment.

Avista believes that a decoupling mechanism can be relatively simple and easy to administer. As described in more detail later in these comments, Avista's proposed alternative mechanism:

- Requires no changes to its current billing system,
- Compares actual usage/margin to Commission authorized usage/margin,
- Records a monthly deferral amount to a balancing account,
- Results in a single annual rate change based on the prior year's deferral balance that could be implemented coincident with the PGA rate change

C. Challenges Related to a Decoupling Mechanism, and Proposed Solutions

One of the most difficult challenges in the consideration of a decoupling mechanism is the determination of the ultimate design of the mechanism itself. Later in these comments, Avista will outline an alternative decoupling mechanism that was developed under the principles identified above. The mechanism is simple in design, easy to understand and implement, and focuses on the objectives of removing the disincentive to pursue energy efficiency, and providing for a more effective and timely recovery of the fixed costs of providing service to customers.

The mechanism would also provide for an after-the-fact transparent review of the results of the mechanism after it has been in place for a period of time.

An additional issue that has been raised in relation to decoupling is whether a reduction in return on equity (ROE) should be made as a result of the implementation of a decoupling mechanism. It is important to consider the answer to this question in the context of why decoupling is being proposed in the first place. Decoupling is being considered because the current rate structure for recovery of the LDC's fixed costs (through a volumetric charge) is not in alignment with the objective of promoting energy efficiency and reduced therm sales. Decoupling would provide the LDC a reasonable opportunity to recover its fixed costs, while also promoting reduced energy usage.

When retail rates are reset in a rate proceeding, the objective or intention is to set rates at a level that will provide recovery of the LDC's fixed costs on a going-forward basis. The ROE established in that same proceeding is based on the LDC having a reasonable opportunity to recover its fixed costs. Therefore, the implementation of decoupling does not provide the LDC with an additional advantage or windfall, it merely provides a more realistic opportunity for the company to recover its fixed costs in the face of energy efficiency efforts and a general decline in therm sales – costs that were intended to be recovered by the utility in the first place.

The appropriate ROE, including a decoupling mechanism, should be determined in the context of an assessment of all the risk born by the LDC and the opportunity for the LDC to recover its costs of service in the current environment in the industry. A current assessment of risks to utilities and the opportunity for cost recovery would not necessarily lead to a conclusion that ROE should be reduced with the implementation of decoupling.

III. COMMENTS ON CASCADE'S PROPOSED MECHANISM & NORTHWEST NATURAL'S OREGON MECHANISMS

A. Cascade's Proposed Decoupling Mechanism

Cascade is to be commended for their innovation associated with their proposed decoupling mechanism (Conservation Rewards Plan). In addition to providing for the recovery of fixed gas distribution costs, Cascade claims their proposed plan will encourage all customers to conserve natural gas. However, it appears that their proposed mechanism would not always provide customers with the best available information regarding their energy conservation.

Weather is a significant variable affecting natural gas usage and Cascade's proposed mechanism does not weather-normalize customers' usage for their "base" usage year (lowest annual usage of the past three years). A customer's lowest annual usage during the past three years will probably, in most cases, be the year with the warmest weather overall. If the weather in the current year is colder than the customer's base year, their usage will most likely be higher. It appears that the implicit message to those customers would be that they are not conserving, whereas on a weather-corrected basis, they may in-fact be conserving. Conversely, if the weather is warmer in the current year as compared to the customer's base year and the customer's usage is lower, the message to the customer would be that they are conserving, whereas on a weather-corrected basis, they may not be.

In order to provide a customer with a reasonable estimate of their energy conservation, their usage should be compared to the number of heating degree-days during the billing period. Usage divided by the number of heating degree-days, together with a simple explanation of the resulting ratio, would provide the customer with more comparable information regarding their usage from year-to-year.

Additionally, Cascade advertises their proposed mechanism as simple to administer, as well as, easy to understand and implement. However, Avista has developed a proposed

mechanism that would be easier to implement, administer and understand, and would equally meet the goals of a decoupling mechanism.

B. Northwest Natural's Oregon Mechanisms

Northwest Natural presently has two separate tariff/mechanisms in place in Oregon. The first is a mechanism that contains an estimate for price-elasticity and defers revenue/margin resulting from the product of the price-elasticity estimate and price changes for natural gas. The second mechanism is their weather-adjustment mechanism (WARM), which ultimately results in each customer being billed a different margin rate each month to adjust for abnormal weather. While there certainly are benefits associated with a "real-time" weather-adjustment each month, Avista believes the complexities involved with implementing and administering these two separate mechanisms outweigh those benefits. Further, Avista's present billing system does not have the capability to bill customers as Northwest Natural does under its WARM mechanism.

IV. AVISTA'S PROPOSED DECOUPLING MECHANISM

A. Overview

Avista has developed a proposed decoupling mechanism based on the principles outlined earlier in these comments. The proposed mechanism removes the disincentive related to promoting energy efficiency, and provides the utility with the opportunity to recover its fixed costs of providing service. The mechanism is easy to understand and implement, and is easy to audit following implementation. The mechanism would not require changes to existing rate structures or billing systems. The Company's proposed mechanism would result in a single annual rate adjustment to reflect the difference between the actual margin (revenue less purchased gas costs) received by the Company during the prior year compared to the level of margin approved by the Commission in the Company's last general filing. The mechanism

incorporates an adjustment for abnormal weather and, as such, could result in a rate surcharge or refund to customers. In order to minimize the number of rate changes customers experience, the decoupling rate adjustment could be implemented at the same time as the Company's annual Purchased Gas Cost Adjustment.

Although there are a number of ways to design a decoupling mechanism to accomplish the intended objectives, we believe that simplicity and ease of understanding in such a mechanism should be a priority. In Oregon, Northwest Natural currently has two different mechanisms in place to address changes in therm sales that affect recovery of non-gas fixed costs. The proposed mechanism outlined below is much simpler and more straightforward than the multiple mechanisms in Oregon, as well as, the mechanism proposed by Cascade.

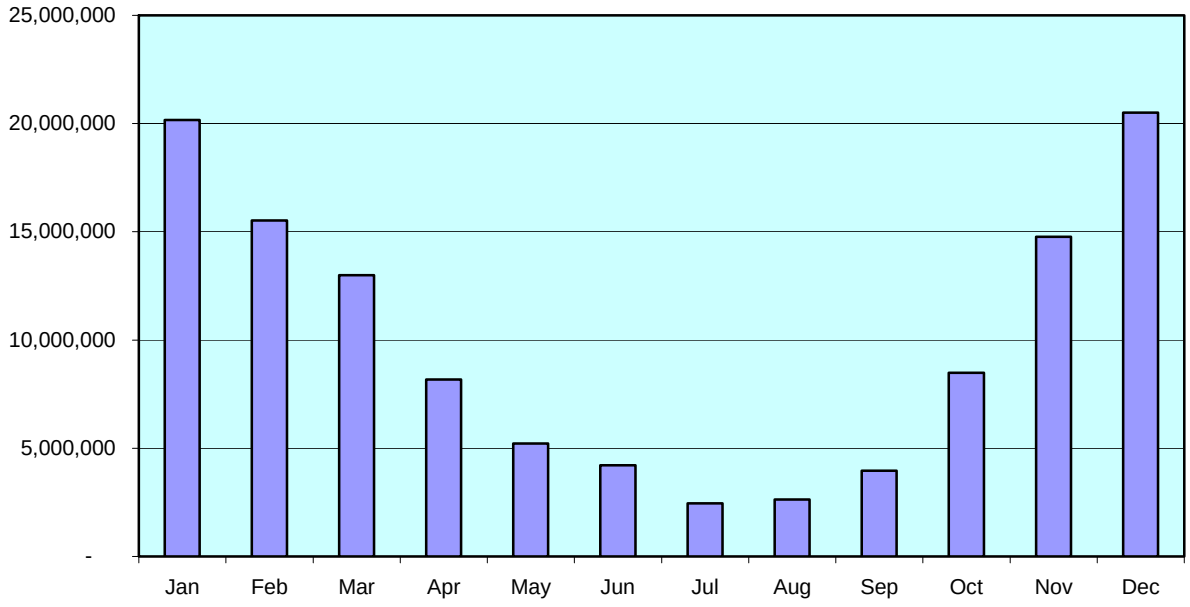
The mechanism would apply to the Company's natural gas Schedules 101 and 111, which include all residential and commercial customers, as well as small industrial customers whose usage is generally weather-sensitive. The mechanism would not be applicable to the Company's approximately 70 large industrial customers served under: High Load Factor Schedule 121, Interruptible Schedule 131, Transportation Service Schedule 146, or special contracts. Generally, the proposed mechanism would compare the actual margin collected from customers each month to the level of margin approved by the Commission from the corresponding month in the test year in order to determine a monthly (deferred) revenue adjustment.

B. Methodology

The recovery of fixed costs for the natural gas utility is based on the weather normalized therm sales included in the last general rate case, i.e., if actual therm sales going forward are equal to the therm sales included the rate case, then fixed costs will be recovered by the utility. Therefore, the starting point for the proposed decoupling methodology is the volume of therm sales for each month of the year from the last general rate case. For ease of reference, I will refer

to these therm sales as "Base Therm Sales." The bar chart below shows the Base Therm Sales for General Service Schedule 101 each month for Avista for illustrative purposes.

Sch 101 Normalized Base Therm Sales



Following the end of each month, the actual volume of therm sales for the calendar month ("Actual Therm Sales) would be determined.[2] Only one adjustment would be made to the Actual Therm Sales. To the extent the Company has added customers since the last rate case, it would result in increased therm sales as compared to the Base Therm Sales. Therefore, in order to have an "apples-to-apples" comparison of Actual vs Base therm sales, an adjustment must be made to remove the usage associated with the new customers.

The adjustment for new customers would be based on the average use-per-customer from the last rate case. Base Therm Sales from the last rate case divided by the number of customers

[2] The current Unbilled Revenue calculations would be included to determine actual therm sales for each calendar month. These calculations are already done on a monthly basis for financial reporting purposes, as well as for the preparation of monthly Results of Operations reports that are provided to the Commission.

associated with those therm sales would provide the average use per customer (Base Use Per Customer). The adjustment for new customers would be calculated each month as follows:

(Actual Customers – Base Customers) x Base Use Per Customer

After the adjustment for new customers, the Actual Therm Sales for the month would be compared with the Base Therm Sales to determine the difference in therm sales. This comparison will capture the effect of both abnormal weather and price elasticity/conservation. This difference would be multiplied by the margin rate (established in the last rate case) to calculate the utility fixed costs that are either under-recovered or over-recovered. These dollars, positive or negative, would be deferred for recovery or rebate.

As an example, the Base Therm Sales in the chart above for January are 20,160,000 therms. Let's also assume that the Base Customers associated with those therm sales are 126,000 customers, which results in a Base Use Per Customer of 160 therms. If Actual Therm Sales for January were 19,900,000 therms and the Actual Customers for the month grew to 130,000, the decoupling calculations for Schedule 101 would be as follows:

Adjustment for New Customers:

(130,000 Actual Customers – 126,000 Base Customers) x 160 therms = 640,000 therms

Deferral for January:

(19,900,000 Actual Therms – 640,000 Therms) – 20,160,000 Base Therms =
-900,000 Therms

-900,000 Therms x $0.194 margin rate = $174,600 fixed cost recovery shortfall

In this example, Actual Therm Sales were lower than the Base Therm Sales and $174,600 of fixed costs were not recovered. The $174,600 for the month of January would be deferred in a

balancing account and accumulated for a twelve-month period.[3] Each month, the decoupling revenue adjustment could be a debit or credit to revenue, depending on the weather and other factors affecting customer usage. At the end of each year, the balance in the account would be transferred to a separate account and a proposed rate adjustment (surcharge or refund) would be calculated to amortize that amount over a prospective twelve-month period. The proposed rate adjustment could be implemented coincident with the Company's annual PGA rate change.

This decoupling proposal would break the link between the volume of therm sales and recovery of fixed costs and would provide for an increased focus on energy efficiency. It is also consistent with the ratemaking objective of providing recovery of the fixed costs of providing service to customers.

[3] The calculation would be separate for Schedule 101 and Schedule 111, and for Schedule 111, the actual and test year usage would be separated into the rate/billing blocks set forth under the Schedule in order to determine the appropriate level of margin.