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BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

REBUTTAL TESTIMONY OF KELLY O. NORWOOD (KON-3T)
REPRESENTING AVISTA CORPORATION

1 **Q. Please state your name, employer and business address.**

2 A. My name is Kelly O. Norwood. I am employed as Vice-President of State and
3 Federal Regulation for Avista Corporation at 1411 East Mission Avenue, Spokane,
4 Washington.

5 **Q. Have you previously submitted testimony in this docket?**

6 A. Yes. I have provided pre-filed direct testimony marked for identification as
7 (KON-1T) and Exhibit _____ (KON-2).

8 **Q. What is the scope of your testimony in this proceeding?**

9 A. As the Company's policy witness in this proceeding, I will respond to specific
10 concerns expressed by Staff and Public Counsel witnesses in their direct testimony
11 regarding the proposed Benchmark Mechanism. I will address concerns related to
12 procurement strategies versus incentive mechanisms, external benchmarks, auditability,
13 lower of cost or market issues, and suggestions that the natural gas management operation
14 be subjected to a competitive bidding process. I will also explain that the design of the
15 Mechanism does not constitute pre-approval of natural gas costs, and how the Mechanism
16 fits within the Commission's 1997 Policy Statement. In addition, I will also introduce the
17 testimony of Mr. Bob Gruber and Mr. Mike D'Arienzo who will respond to Staff and
18 Public Counsel testimony in more detail.

19 **Q. Mr. Parvinen has characterized the Benchmark Mechanism as a**
20 **purchasing strategy or pricing mechanism. Is it simply a purchasing strategy or is it**
21 **more than that?**

22 A. While the Benchmark Mechanism includes a purchasing strategy, the
23 Mechanism is much more than that. First, the purchasing strategy built into the Benchmark

(KON-3T)

1 Mechanism is a strategy developed by Avista Utilities, in consultation with Avista Energy,
2 to provide additional stability to customers' rates over time. As has been explained in
3 detail in our direct case in this proceeding, the strategy involves a portfolio of natural gas
4 purchases with some natural gas purchased a year in advance, some a month in advance,
5 and some on a daily basis, together with seasonal and daily use of gas storage to reduce and
6 stabilize costs. This is not a situation in which Avista Utilities has turned over the gas
7 procurement functions to Avista Energy and then turned its back hoping that Avista Energy
8 will do a good job for Avista Utilities' customers.

9 The Benchmark Mechanism operates under the supervision of the Strategic
10 Oversight Group, which meets on a periodic basis, and consists of a team of employees
11 from both Avista Utilities and Avista Energy. Avista Utilities' employees participating in
12 the Strategic Oversight Group include the Manager of Natural Gas Resources, the Manager
13 of Risk Management and representatives from accounting and rates. Ms. Elder has
14 recognized the benefit of this collaborative effort on behalf of ratepayers on page 8 of her
15 testimony where she states that "The incentive reward is actually paid to AE, and AE and
16 Avista Utility employees work together in making key decisions on behalf of ratepayers."

17 In addition, the purchasing strategy is the strategy that would be employed by the
18 Utility if the natural gas procurement functions were housed within Avista Utilities instead
19 of Avista Energy. The real benefit to the Benchmark Mechanism, however, comes with
20 Avista Energy carrying out the purchasing strategy and optimizing the available
21 transportation and storage assets in a way that reduces the overall costs for Avista Utilities'
22 customers.

1 **Q. Do Avista Utilities' customers benefit from Avista Energy's stronger**
2 **market presence?**

3 A. Yes. On page 52 of his testimony, Mr. Parvinen states that Avista Energy's
4 management of the natural gas procurement functions for Avista Utilities provides Avista
5 Energy with "market presence," e.g., increased volumes of transactions and increased
6 participation in the market which may provide increased opportunities to create or extract
7 value. A close look at the numbers, however, reveals just the opposite to be true. As
8 stated in the Company's direct testimony, the Avista Utilities' natural gas volumes
9 managed by Avista Energy amount to less than 3% of Avista Energy's total business, and
10 therefore, are not a material portion of their overall business. Through the Benchmark
11 Mechanism, Avista Energy actually provides Avista Utilities with market presence in that
12 Avista Utilities' customers receive the benefits that are provided by being a part of a
13 significantly larger natural gas portfolio.

14 **Q. Would termination of the Mechanism result in the loss of benefits to**
15 **customers?**

16 A. Yes. Unless there are compelling reasons based on sound analysis and
17 documentation, the Benchmark Mechanism should not be terminated, resulting in the loss
18 of benefits to customers. In the Company's filing in this case, as well as through discovery
19 and meetings with Staff and Public Counsel, Avista Utilities and Avista Energy have
20 provided extensive detailed analysis of the benefits to Avista Utilities' customers through
21 the Benchmark Mechanism of a approximately of \$2.6 million annually, and benefits to
22 Avista Energy of approximately \$1.0 million annually.

1 Staff and Public Counsel's recommendations to terminate the Benchmark
2 Mechanism are based, at least in part, on erroneous assumptions and perhaps a
3 misunderstanding of the operation of the Mechanism. Mr. Gruber and Mr. D'Arienzo will
4 address these issues in detail.

5 In summary, the Benchmark Mechanism is much more than a purchasing strategy
6 or pricing mechanism. In addition to the purchasing strategy, it is an incentive mechanism
7 that aligns the interests of Avista Utilities' customers and Avista Energy through a
8 symmetrical sharing (80% to customers/20% to Avista Energy) of the costs and benefits of
9 the natural gas procurement functions. The incentive mechanism is set up such that for
10 every dollar of benefit that Avista Energy receives, Avista Utilities' customers receive four
11 dollars through the 80%/20% sharing. In addition, the incentive mechanism is structured
12 such that Avista Energy does not benefit unless Avista Utilities' customers benefit. The
13 arrangement with Avista Energy provides confidence in reliable supply for our customers,
14 control and flexibility to make changes to purchasing strategies as necessary over time,
15 built-in incentives to cause Avista Energy to create value and lower overall costs to our
16 customers, and full access to all records at Avista Energy for audit and review.

17 The Benchmark Mechanism is well-structured, well-thought out and has been
18 refined over time through the experience gained in the operation of the mechanism over the
19 past four years in Washington, Idaho, and Oregon, and should be continued.

20 **Q. What is the status of the Benchmark Mechanism in other jurisdictions in**
21 **which the mechanism in place?**

1 A. The Idaho and Oregon Commissions originally approved the Benchmark
2 Mechanism in 1999, and in 2002 extended it through March 31, 2005. The Idaho Staff
3 stated in their comments dated January 11, 2002:

4 “This pricing methodology is very similar to the long-term contracts method except
5 it protects customers from daily price swings by shifting daily volatility to Avista
6 Energy. ... Staff is generally satisfied with the current Benchmark Mechanism for
7 three reasons: customers have paid a reasonable price for the fuel they have used;
8 customers have benefited from storage and off-system sales; and reliability has not
9 been sacrificed.”

10
11 In addition, in comments filed by the Oregon Commission Staff on March 12, 2002,
12 they stated:

13 “The GBM provides an incentive to Avista Utilities to minimize natural gas costs
14 by consolidating the natural gas procurement function under Avista’s affiliate,
15 Avista Energy. It also provides gas cost savings to Oregon customers, and because
16 Avista Corporation and its shareholders take on more risk related to gas
17 procurement operations than under the Purchased Gas Adjustment (PGA), there is
18 less risk to Oregon customers... .”

19
20 The Benchmark Mechanism continues to operate successfully in both Idaho and
21 Oregon and has been refined over time based on the experience gained and periodic
22 discussions with the respective Commission Staffs. Although there are some differences in
23 the Benchmark Mechanism in Washington, Idaho and Oregon, all contain a purchasing
24 strategy that includes a portfolio approach to natural gas acquisition, as well as incentive
25 components to align the interests of Avista Utilities’ customers and Avista Energy. The
26 Benchmark Mechanism in Idaho and Oregon are also both operated under the supervision
27 of the same Strategic Oversight Group.

28 **Q. Before turning to Staff’s and Public Counsel’s concerns, please describe**
29 **the areas of agreement around the Benchmark Mechanism.**

1 A. In this Docket, the Company has proposed a number of improvements to the
2 Benchmark Mechanism, several of which were designed to address specific concerns raised
3 by Staff. The more significant proposed changes include modifications to provide direct
4 benefits to customers from the value of supply basin price differentials (basin
5 optimization), greater use of storage to cover daily load variations, symmetrically shared
6 incentives, and improved auditability. Please see page 5 of my direct testimony (KON-1T)
7 for these modifications.

8 There is a significant amount of agreement around the operation of the Benchmark
9 Mechanism. Areas of general agreement include:

- 10 1) A tiered purchasing strategy with Tier 1 hedges at 50% of total estimated load, Tier 2
11 natural gas purchases at First of the Month (FOM) index pricing for the remaining 50%
12 of estimated monthly load, and managing Tier 3 intra-month daily load volatility with
13 storage and daily pricing. This portfolio approach provides a reasonable balance of
14 price stability and low cost supply for Avista Utilities' customers.
- 15 2) Use of Jackson Prairie storage to capture summer/winter price differentials and peak
16 days, as well as to manage daily load swings when economically feasible and reliability
17 is not sacrificed.
- 18 3) Use of pipeline capacity releases and off-system sales to gain additional value for
19 Avista Utilities' customers.
- 20 4) Optimize supply basin price differentials to the benefit of Avista Utilities' customers.
- 21 5) Reduce price fluctuations and risk for Avista Utilities' customers through the
22 purchasing strategy.

1 6) Align the interests of Avista Energy with Avista Utilities' customers such that Avista
2 Energy is rewarded only when Avista Utilities' customers benefit.

3 Q. In Ms. Elder's testimony on page 4 she describes a typical
4 incentive structure. Is the Mechanism consistent with this description?

5 A. Yes. Ms. Elder's description of the typical incentive structure on
6 page 4 of her testimony is as follows:

7 Q. Please describe a typical incentive structure.

8 A. A typical structure establishes a reasonable benchmark cost of gas (e.g. a
9 certain dollar amount per MMBtu or a formula used to calculate an average
10 gas cost) that reflects what ratepayers should expect to pay if the gas were
11 purchased by a prudent gas manager without an incentive mechanism. If
12 and when an LDC "beats" that benchmark to achieve a lower gas cost, it is
13 rewarded with a percentage of the difference between actual cost and the
14 benchmark. In other words, it receives a share of the savings it achieved on
15 behalf of ratepayers. The converse would be true, as well, such that the
16 LDC shares in whatever costs it incurs above the benchmark." (underscores
17 added)
18

19 This is precisely what occurs within the Benchmark Mechanism. The "formula" is
20 the purchasing strategy chosen by Avista Utilities, i.e., Tier 1 storage and fixed price
21 transactions for 50% of the portfolio, and Tier 2 FOM index purchases for the remaining
22 50% of the portfolio. This portfolio is illustrated on the chart on page 1 of Exhibit ____
23 (KON-4). The solid line on the chart reflects the estimated average Avista Utilities' load
24 for each month, November through October. The segments on the bar chart reflect the Tier
25 1 and Tier 2 purchases to serve the total estimated load.

26 It is Avista Utilities' intention that the prices for the Tier 1 purchases made 6 to 18
27 months in advance remain fixed in order to provide a level of price stability for our
28 customers. This is part of the hedging strategy adopted by Avista Utilities as part of what it

1 believes is prudent gas management, and we do not want the prices for this portion of the
2 portfolio (approximately 50% of the volume) to change. Therefore, for this particular
3 component, Avista Utilities has not proposed, nor do we want, a sharing of costs related to
4 this portion of the portfolio.¹

5 For the remainder of the portfolio, however, Avista Utilities has proposed a
6 benchmark and a sharing of costs and benefits around that benchmark. Under the
7 Mechanism, the remaining 50% of the portfolio is purchased at the FOM index prices,
8 which is the benchmark for the balance of the portfolio. These Tier 2 volumes are
9 illustrated on page 1 of Exhibit ____ (KON-4), and are purchased in advance to cover the
10 remaining estimated average load for each month.

11 On a day to day basis within the month, to the extent that actual daily loads exceed
12 the available Tier 2 volumes for the month, Tier 3 daily purchases are made to balance the
13 total supply for the day with the actual load. Conversely, if actual daily loads within the
14 month are lower than the available Tier 2 volumes for the month, Tier 3 daily sales are
15 made to balance supply with actual load.² This daily volatility is also illustrated on the
16 chart.

17 Under the Benchmark Mechanism, a symmetrical sharing incentive is applied to
18 these daily Tier 3 transactions to provide an incentive for Avista Energy to minimize the
19 costs associated with covering this daily load volatility. The incentive is set up such that if
20 the costs of these daily transactions differ from the Tier 2 FOM index costs, this difference,

¹ Avista Energy makes specific Tier 1 purchases on behalf of Avista Utilities to lock in these prices, and the specific contracts executed by Avista Energy are placed in a file and are available for Avista Utilities and Commission Staff to audit and to verify the prudence of the transactions. These transactions occur under the supervision of the Strategic Oversight Group.

1 up or down, is shared 80% to customers and 20% to Avista Energy. Therefore, Avista
2 Energy clearly has an incentive to meet or beat the benchmark, otherwise it absorbs 20% of
3 the difference in costs.

4 For reporting and auditing purposes, the Company proposes a Daily Log to record
5 all Tier 1, Tier 2 and Tier 3 commodity transactions, which will include the benchmark
6 comparisons on a daily basis. This Daily Log will be a part of the documentation and audit
7 trail for Avista Utilities and Commission Staff, and will be included in the quarterly reports
8 to the Commission. This Daily Log can be made readily available to Staff for their review.
9 A sample Daily log is attached to my testimony as Exhibit ____ (KON-5) and Mr. Gruber
10 provides additional explanation related to this Daily Log.

11 **Q. Staff also asserts that the auditability of the Benchmark Mechanism is**
12 **problematic. Do you agree?**

13 A. No, as I described in my direct testimony beginning at page 12, the
14 Benchmark Mechanism with the proposed modifications provides an excellent audit trail.
15 Storage and Transportation costs are transaction specific and are easily tagged and
16 auditable as belonging to the Utility. The Tier 1 commodity transactions that I just
17 described above are tagged by Avista Energy for the Utility and are directly auditable. The
18 remaining 50% of Avista Utility's average load, under Tier 2, is purchased in advance at
19 FOM index prices. These transactions will also be tagged and are auditable by the Utility.
20 The Tier 3 daily transactions are a relatively small portion of the overall portfolio at
21 approximately plus or minus 8% of the total volumes.

² The Mechanism also provides for withdrawals from storage to be used to cover daily load volatility as it is available and economic.

1 The Daily Log that I referred to above, will show all transactions that occur on
2 behalf of the Utility, whether they involve commodity transactions in Tier 1, Tier 2, or Tier
3 3, as well as transactions related to storage and transportation. Although the actual terms
4 used by Avista Energy to balance the daily load volatility for the utility will not be traced
5 back to specific purchases for the utility, these volumes at plus or minus 8% of total load
6 are relatively small. This daily balancing will be served as part of Avista Energy's overall
7 portfolio of loads and the price to Avista Utilities' customers will be based on the average
8 price of Avista Energy's actual transactions for the day, which themselves will be available
9 to audit. In Tier 3, Avista Utilities' customers actually benefit from Avista Energy's active
10 management of this daily volatility and the 80%/20% sharing of the costs.

11 Therefore, the Company's proposal in this filing results in the opportunity to audit
12 all revenues and expenses under the Benchmark Mechanism.

13 **Q. One of Mr. Parvinen's recurring themes is that the Benchmark**
14 **Mechanism is not simple to understand. Do you agree?**

15 A. No. The Benchmark Mechanism is actually very straightforward given the
16 complexity of managing natural gas procurement operations. The Benchmark Mechanism
17 is a portfolio of commodity supply, storage flexibility, and optimization of available
18 pipeline transportation. The Oregon Staff reached a similar conclusion. In its March 12,
19 2002 Staff Report, the Staff stated at page 8: "The mechanism provided a simple,
20 objective determination of the costs to be charged to customers that could not be gamed or
21 manipulated." The Oregon Commission Staff came to this conclusion while clearly
22 acknowledging that Avista Energy blends Oregon gas with that of other states.

1 **Q. The Staff asserts that incorporating the Benchmark Mechanism in a**
2 **tariff remains an issue. What is the Company's response to this concern?**

3 A. The Policy Statement's Guiding Principle 14 requests that Purchased Gas
4 Adjustments (PGA) procedures be tariffed, and Guiding Principle 15 notes the
5 Commission's authority to review the prudence of deferred gas cost filings. The Company
6 has sought to comply with Guiding Principle 14, through its Benchmark Mechanism tariffs,
7 and recognizes the Commission's interest in reviewing the Benchmark Mechanism in
8 proceedings such as this one.

9 In the Company's view, approval of the Benchmark Mechanism by the Commission
10 in this proceeding does not constitute pre-approval of natural gas costs. The Commission
11 retains its authority to review and adjust Avista Utilities' gas costs during a PGA
12 proceeding.

13 **Q. At pages 19 and 20 of his direct testimony, Mr. Parvinen appears to**
14 **imply that the National Association of Regulatory Utility Commissioners (NARUC)**
15 **adopted a resolution endorsing a lower of cost or market standard. Do you agree**
16 **with this implication?**

17 A. No. I believe that Mr. Parvinen's answer on page 20 of his testimony quoting
18 a portion of this resolution clearly provides a measure of flexibility for the application of
19 the lower of cost or market standard. The quoted passage from the NARUC resolution
20 begins with the term, "generally," and concludes with the sentence: "Under appropriate
21 circumstances, prices could be based on incremental cost or other pricing mechanisms as
22 determined by the regulator." (underscore added) Therefore, the NARUC resolution does
23 not, on its face, require the lower of cost or market standard as it provides appropriate

(KON-3T)

1 deference to Commissioners to authorize a mechanism suitable for their jurisdictional
2 utilities.

3 The transactions at issue here (in Tier 3) involve relatively small volumes to
4 balance load on a day to day basis. The price to Avista Utilities' customers for these daily
5 volumes is the average cost to Avista Energy from the market on the respective day. From
6 an operating standpoint, once you reach the current day and there is an imbalance for the
7 day, apart from storage, there is no place to go but to the daily market to purchase to meet
8 the deficit, or sell to eliminate the surplus. Therefore, the concerns that Mr. Parvinen raise
9 regarding the lower of cost or market are related to "form" and not "substance," because
10 any dollar differences related to attempting to trace specific therms delivered to the Utility
11 back to specific market transactions for the day, versus simply using the average market
12 price for the day, would be immaterial. In fact, as Mr. D'Arienzo will explain in his
13 testimony, Avista Energy conducted an analysis to compare their average daily purchases
14 and sales prices with the Gas Daily published indices for the year 2002, and found that
15 there was no significant variances between the two.

16 **Q. In his testimony beginning on page 23, Mr. Parvinen expresses concern**
17 **that "individual therms cannot be tracked," and that the specific costs associated**
18 **with each of those therms cannot be identified. Do you have any comments on this**
19 **testimony?**

20 **A.** Yes. First, as I stated before, the volumes at issue here are the relatively small
21 Tier 3 purchases and sales to balance daily load volatility. Second, both the natural gas and
22 electric industry do not attempt to trace or "color-code" the natural gas molecules or
23 electrons from one location to another. The reality is that when you purchase energy you

(KON-3T)

1 end up with a contract right to a specific volume, delivered to a specific location, at either a
2 negotiated fixed price or a market price determined at the time of delivery. That is the way
3 the industry works, and that is the way the Benchmark Mechanism works.

4 Furthermore, on page 3 of her testimony, Ms. Elder states as follows:

5 Procurement incentives are an alternative to a plain "pass-through" mechanism, by
6 which an LDC passes its actual cost of gas, no more and no less, on to its
7 ratepayers, often after a finding that the costs were incurred prudently.
8 (Underscores added)
9

10 As Ms. Elder points out, an incentive mechanism is an alternative to a straight pass-
11 through of actual costs. Under an incentive mechanism, there is a sharing of costs and
12 benefits such that a portion of the costs and benefits go to customers and a portion to
13 shareholders. Therefore, by definition, under an incentive mechanism the "actual costs" of
14 the specific natural gas molecules used to serve customers are not passed through to
15 customers in any event.

16 **Q. Staff and Public Counsel assert that the benefits to Avista Energy are**
17 **greater than that due Avista Energy. What are the benefits to Avista Energy?**

18 A. Confidential Workpaper 5, provided with the Company's direct case, includes
19 a summary of an extensive analysis showing that the benefits to Avista Energy under the
20 Benchmark Mechanism are in the range of \$1 million annually. Mr. Gruber has sponsored
21 this summary page as Confidential Exhibit ____ (RHG-5C). By comparison, the estimated
22 benefits to customers are approximately \$2.6 million annually.

23 The 80%/20% incentive mechanism has been designed such that Avista Energy has
24 an incentive to drive value from each component, and not favor one over the other. This
25 helps insure that Avista Energy's interests are aligned with Avista Utility's customers and

(KON-3T)

1 insure that Avista Energy only benefits if its management of commodity, transportation and
2 storage provides benefits to Avista Utilities' customers.

3 Also as previously discussed in the Company's direct testimony, because Avista
4 Energy is a subsidiary of Avista Corporation its interests are aligned with those of the
5 Utility, since the Utility is the core of the Corporation. Therefore, it is in Avista Energy's
6 best interest that Utility customers receive the best price and service possible.

7 **Q. Staff and Public Counsel state that the Benchmark Mechanism is not**
8 **sufficiently aligned with the Commission's Policy Statement on incentives for PGAs.**
9 **What is the Company's perspective on this?**

10 A. The Company continues to believe that the proposed incentive Mechanism
11 conforms to the spirit and intent of the Commission's Policy Statement, as well as its
12 Guiding Principles. Exhibit ____ (KON-6) shows each Guiding Principle and the
13 Company's response. The Company specifically addresses each Guiding Principle in this
14 Exhibit and demonstrates that the proposed Benchmark Mechanism addresses or, at a
15 minimum, is not inconsistent with each Guiding Principle. This Exhibit is intended to
16 respond to Mr. Parvinen's direct testimony at pages 38 through 47 and Ms. Elder's
17 testimony at page 3.

18 I would like to touch on two key aspects of the Policy Statement. First, the
19 Commission was very clear about the applicability of the Policy Statement. At page one,
20 the Commission states: "The statement does not constitute a formal order binding upon
21 either the Commission or the parties that may come before it in formal proceedings, nor is
22 this policy statement a rule. It is neither feasible nor practicable to adopt a rule at this time,

1 as these principles are not perfected so as to be binding on either the Commission or
2 LDCs." (underscore added)

3 Second, it is important to note that Guiding Principle 10 recognized that each LDC
4 should be allowed to file a mechanism that is specific to its needs. This principle clearly
5 provides flexibility for the adoption of the Company's Benchmark Mechanism.

6 **Q. Does Mr. Parvinen suggest in his testimony that the principles adopted in**
7 **the 1997 Policy Statement should be followed to the letter?**

8 A. No. On page 38 of his testimony he states that "for the most part, the
9 principles contained in the Commission's Policy Statement remain fundamentally sound."
10 (underscore added)

11 Furthermore, on page 47 of his testimony he has included the following question
12 and answer:

13 Q. Is Avista's Benchmark Mechanism consistent with Principle No. 14, which
14 states that gas cost procedures be tariffed?

15 A. Yes, but that creates other problems.
16

17 Therefore, Mr. Parvinen has provided contradictory testimony related to the
18 Benchmark Mechanism's compliance with the Policy Statement. With regard to Principle
19 No. 14, he has stated that the Benchmark Mechanism is consistent with the Policy
20 Statement, but the fact that it is consistent is problematic. On the other hand, one of Mr.
21 Parvinen's primary reasons for recommending that the Mechanism be rejected is that the
22 Mechanism is not consistent with the Policy Statement.

23 Unless there is a compelling reason to unwind the mechanism, the Benchmark
24 Mechanism should continue. To do otherwise would be to the detriment of Avista

1 Utilities' customers in Washington, as well as those in Idaho and Oregon. We should "not
2 throw the baby out with the bath water."

3 **Q. Staff presents three alternative recommendations regarding Avista**
4 **Utilities' natural gas operations. What is the Company's response to the Staff's first**
5 **alternative of allowing the Benchmark Mechanism to terminate and have natural gas**
6 **procurement functions revert back to Avista Utilities or have these functions bid out**
7 **to third party?**

8 A. As I explained in my direct testimony, Avista Utilities' customers benefit
9 from the services provided by Avista Energy under the Benchmark Mechanism as
10 compared to these functions being performed by Avista Utilities. Thus, the Company
11 disagrees with Mr. Parvinen's recommendation in this regard.

12 Putting gas supply management functions out for competitive bid would be
13 problematic. There would likely be less of an audit trail for Avista Utilities and for
14 Commission Staff as there would be no Commission authority over the third-party entity
15 and no relationship between Avista Utilities and that entity to have access to the amount of
16 transaction information that we have access to today from Avista Energy. All of Avista
17 Energy's records, as they relate to the Benchmark Mechanism, are open for audit and
18 review by Avista Utilities and Commission Staff at any time. While the Commission
19 Staff's interest in having an "arms-length transaction" would be met, remaining issues of
20 prudence and auditability may be greater.

21 Moreover, the Company would be concerned about maintaining control and
22 reliability of supply which is possible through its relationship with Avista Energy, but not
23 with an independent third party. The overriding concern of Avista Corporation in natural

1 gas procurement is providing reliable natural gas supply to Avista Utilities' customers with
2 pricing that reflects an appropriate balance of low cost and price stability. This may not be
3 the primary perspective of a third-party provider during periods of stress on the supply
4 system or that entity's financial status. A close relationship is necessary between Avista
5 Utilities and a natural gas provider. This would require finding the right business partner
6 in a competitive situation, which is difficult in today's environment of weakened energy
7 marketing firms.

8 In short, the current arrangement provides confidence in reliable supply for our
9 customers, control and flexibility to make changes to purchasing strategies as necessary
10 over time, built-in incentives to cause Avista Energy to create value and lower overall costs
11 to our customers, and full access to all records at Avista Energy for audit and review. Such
12 an arrangement would not be possible with a third party.

13 **Q. What is the Company's response to Staff's second and third alternative**
14 **recommendations?**

15 A. Both alternatives would have the effect of an inappropriate increase in risk to
16 Avista Energy and increase in benefits to Avista Utilities' customers. As is explained in
17 the testimony of Mr. Gruber and Mr. D'Arienzo, Staff is proposing unreasonable levels of
18 cost on Avista Energy. The Company rejects these alternatives as not being an appropriate
19 sharing of benefits between Avista Utilities' customers and Avista Energy.

20 Again, the Company believes that the audit trail and Daily Log should be
21 responsive to the Commission Staff to ascertain that Avista Utilities' customers are
22 experiencing net benefits and that Avista Energy is not unduly benefiting from the
23 Benchmark Mechanism.

1 **Q. Would you please introduce the other witnesses representing Avista in**
2 **this proceeding, and provide a brief summary of their rebuttal testimony?**

3 A. Yes. Mr. Bob Gruber is the Manager of Natural Gas Resources for Avista
4 Utilities and will be sponsoring testimony on behalf of Avista Utilities. Mr. Mike
5 D'Arienzo is the Vice President of Natural Gas Marketing and Trading for Avista Energy
6 and will be sponsoring testimony on behalf of Avista Energy. Between them, Mr. Gruber
7 and Mr. D'Arienzo have over 40 years of operating experience in the natural gas industry
8 relating to commodity procurement, transportation and natural gas storage.

9 Mr. Gruber's testimony will focus primarily on two areas of the testimony of Mr.
10 Parvinen and Ms. Elder, relating to their analysis of the level of benefits provided to
11 customers through the Benchmark Mechanism. The first is Staff's assessment of the cost of
12 supplying the Tier 3 intra-month daily load volatility. Mr. Gruber explains that due to
13 several serious flaws in Staff's analysis, it has reached the incorrect conclusion that moving
14 this function back into the Utility would reduce costs to customers. The second area of
15 major concern is with both Staff's and PC's analysis of the value of capacity releases and
16 off-system sales. Errors in this analysis have resulted in a significant overstatement of the
17 value of available transportation for capacity release and off-system sales.

18 Mr. D'Arienzo in his testimony, will clarify how the Benchmark Mechanism is
19 managed as part of Avista Energy's business. He will provide information, in response to
20 Staff and Public Counsel's assertions with respect to the benefits to customers and
21 auditability of the mechanism, risks and rewards for Avista Energy, as well as clarify where
22 Staff and Public Counsel's analysis do not reflect the actual value and daily operation of
23 the Mechanism.

1

Q. Does that conclude your prepared rebuttal testimony?

2

A. Yes it does.

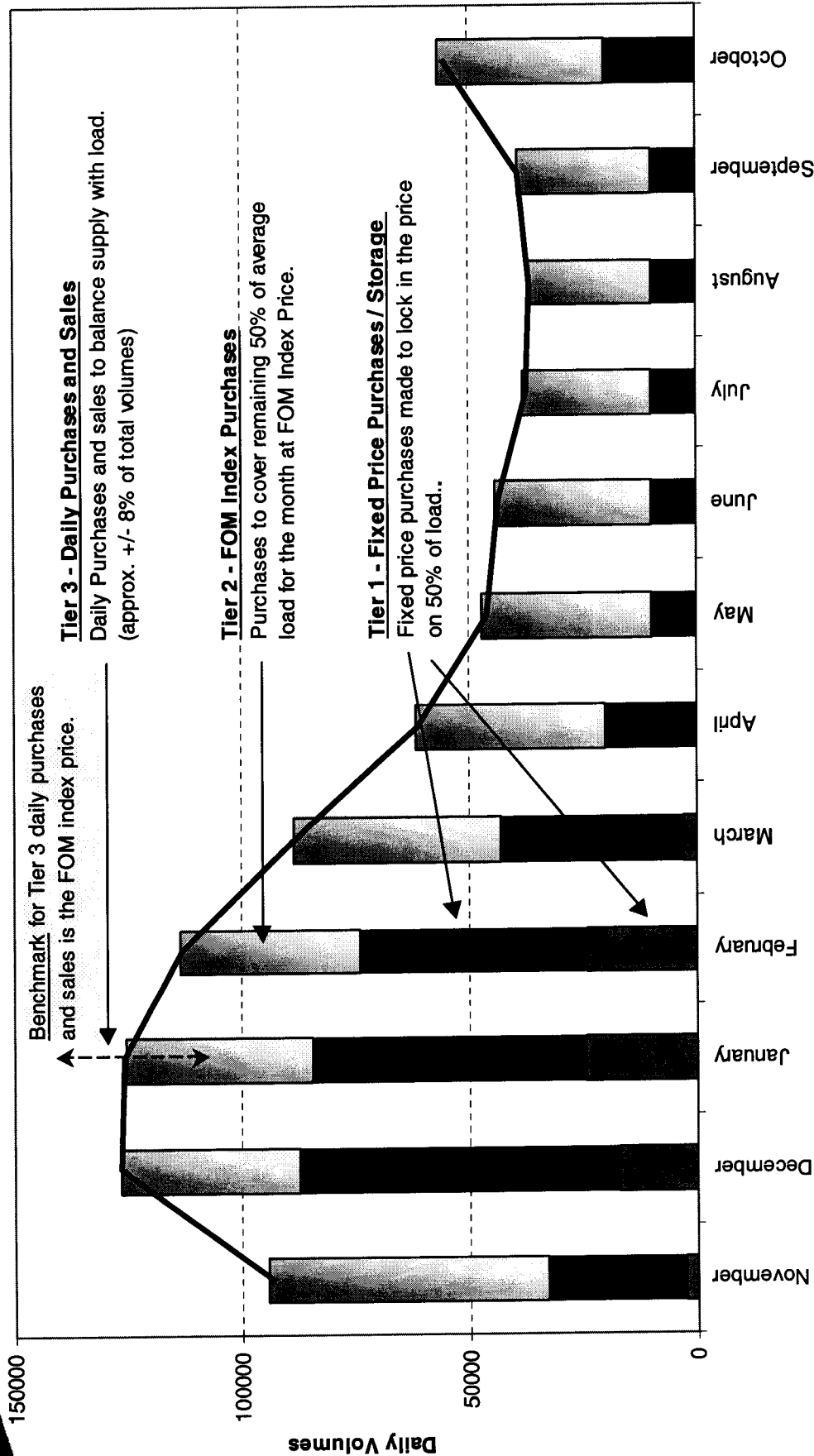
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BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

EXHIBIT ____ (KON-4)

Illustration of Gas Procurement Strategy and External Benchmark



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BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

EXHIBIT ____ (KON-5)

Daily Log
February 24, 2004

(Dates and Numbers are for Illustrative Purposes Only)

Avista Utilities Monthly Load and Transportation Characteristics					
Average Load		84,767			
Total Delivered		105,147			
Basin Balance					
Transport	Sumas	18,015			
Transport	Rockies	23,246			
Transport	AECO	55,578			

Tier 1 - Fixed Price Purchases					
		Basin Balance	Fixed Price	Gas Cost	
Tier 1 Fixed	Sumas	6,300	\$4.50	(\$28,350.00)	
Tier 1 Fixed	Rockies	8,750	\$3.00	(\$26,250.00)	
Tier 1 Fixed	AECO	19,950	\$4.25	(\$84,787.50)	
Tier 1 Storage	JP	17,500	\$4.50	(\$78,750.00)	
Tier 1	Total	52,500		(\$218,137.50)	

Tier 2 - FOM Index Purchases					
		Basin Balance	FOM Index	Gas Cost	
Tier 2 Index	Sumas	5,808	\$4.76	(\$27,646.37)	
Tier 2 Index	Rockies	8,067	\$3.14	(\$25,329.60)	
Tier 2 Index	AECO	18,392	\$4.72	(\$86,888.38)	
Tier 2	Total	32,267		(\$139,864.34)	

Tier 3 Daily Load Balancing						
		Basin Balance	Buy/(Sell)	Weighted FOM	GD Index	Benefit/(Loss)
Tier 3	Sumas	18,015	0	\$4.33	\$5.79	
Tier 3	Rockies	23,246	0	\$4.33	\$4.45	
Tier 3	AECO	46,386	20,380	\$4.33	\$6.41	(\$42,227.48)
Tier 3	JP	17,500	0			
Tier 3	Total	105,147	20,380			(\$42,227.48)

Storage Optimization						
		Basin Balance	Buy/(Sell)	Day Price	Forward Price	Benefit/(Loss)
Daily Storage Optimization		0				\$0.00
Daily Storage Optimization		Total				\$0.00
			Fixed Price	Weighted FOM		
Winter Summer Differential		Total	17,500	\$4.50	\$4.33	(\$2,894.61)
Storage Optimization		Total				(\$2,894.61)

Capacity Optimization						
		Basin Balance	Buy/(Sell)	FOM Index	GD Index	Benefit/(Loss)
Off-System Sales	Sumas	(0)			\$ 5.785	\$0.00
Off-System Sales	Rockies	0			\$ 4.450	\$0.00
Off-System Sales	AECO	9,192			\$ 6.407	\$0.00
Off-System Sales	Total					\$0.00
		Release				Benefit/(Loss)
Capacity Releases	Sumas					\$0.00
Capacity Releases	Rockies					\$0.00
Capacity Releases	AECO					\$0.00
Capacity Releases	Total					\$0.00
Capacity Optimization		Total				\$0.00

Basin Optimization						
		Basin Balance	Buy/(Sell)	FOM Index	GD Index	Benefit/(Loss)
FWD Basin Opt	Sumas	0	(12,108)	\$4.76		\$57,634.08
FWD Basin Opt	Rockies	23,246	6,429	\$3.14		(\$20,187.51)
FWD Basin Opt	AECO	44,021	5,679	\$4.72		(\$26,829.54)
FWD Basin Opt	JP	17,500				
FWD Basin Opt	Total	84,767	0			\$10,617.04
		Basin Balance	Buy/(Sell)	FOM Index	GD Index	Benefit/(Loss)
Daily Basin Opt	Sumas	18,015	18,015		\$5.79	(\$104,216.78)
Daily Basin Opt	Rockies	23,246	0		\$4.45	\$0.00
Daily Basin Opt	AECO	26,006	(18,015)		\$6.41	\$115,414.90
Daily Basin Opt	JP	17,500	0			
Daily Basin Opt	Total	84,767	0			\$11,198.12
Total Basin Optimization						\$21,815.16

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BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

EXHIBIT ____ (KON-6)

Avista Utilities
Benchmark Mechanism Compliance with Commission
Policy Statement in Docket No. UG-970001
EXHIBIT__ (KON-5)

Policy #	Utility Compliance
<p>1. The Commission shall consider gas cost incentive mechanisms that reward companies based on performance relative to an external benchmark of market gas cost. The benchmark should be used in conjunction with the current PGA/deferral process. PGA rates, as price signals, should provide the most accurate estimate of expected gas costs and should be based on the Company's most accurate estimate of prospective gas costs, with deferral accounting and true-up of revenues collected to actual costs. The sharing mechanism should be based on a comparison of actual gas costs to a benchmark.</p> <p>2. Total gas costs should be included in the benchmark, including fixed and variable transportation costs, fixed and variable commodity costs, and fixed and variable storage costs.</p> <p>3. Incentive mechanisms should be simple to understand and apply, avoiding complex calculations which could lead to disputes or gaming.</p> <p>4. The gas commodity portion of incentive mechanisms should judge performance against a benchmark for gas costs based on market prices, not an LDCs' historic gas costs. Using an external benchmark for the commodity portion will provide LDCs with the incentive to perform better than the market.</p> <p>5. Revenue and risk sharing should be symmetrized between the company and ratepayers, i.e., incentive proposals should incorporate a risk of loss from poor performance as well as opportunities for rewards from good performance.</p> <p>6. 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.</p>	<p>The commodity component of the Benchmark Mechanism is designed such that Avista Energy's performance is based on a comparison to an external benchmark of gas cost. (See pages 7-9 of Mr. Norwood's testimony (KON-3T))</p> <p>The Benchmark is used in conjunction with the Company's current PGA deferral process. PGA rates are based on the Company's most accurate estimate of prospective gas costs with deferral accounting and true-up of revenues collected to actual costs.</p> <p>With regard to a comparison of actual gas costs to a benchmark, see pages 11-13 of Mr. Norwood's testimony (KON-3T).</p> <p>All of the gas costs that are generally included in the Company's PGA process are managed under the proposed Benchmark Mechanism.</p> <p>Given the complexity of managing natural gas procurement operations, the Benchmark Mechanism is relatively straightforward. It is a portfolio of commodity supply, storage flexibility, and optimization of available pipeline transportation. The Company has proposed a Daily Log that will serve to simplify the audit and review process.</p> <p>The commodity portion of the Benchmark Mechanism includes an external benchmark of market prices, against which to measure performance. See pages 7-9 of Mr. Norwood's testimony (KON-3T).</p> <p>The proposed Benchmark Mechanism includes a symmetrical sharing of 80/20 around all components of the Mechanism, which incorporates a risk of loss from poor performance as well as opportunities for rewards from good performance. See page 1 of Mr. Norwood's Exhibit__ (KON-2).</p> <p>Dead bands are not mandatory under this policy. The Company has chosen a tiered approach to mitigate price risks and believes it is in the best interest of the utility's customers.</p>

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Policy #	Utility Compliance
<p>7. Incentive mechanisms should be structured as an experiment, so should have limited duration and should be explicitly evaluated at the end of the period to determine success or failure.</p>	<p>The original Benchmark Mechanism and each subsequent extension followed this policy and set up an experimental period of three years or less. An evaluation period at the end of each term allowed for review by the Commission. In addition, Staff has the ability to review all costs included annually within the PGA filing process.</p>
<p>8. Proposals for incentive PGAs should include documentation to demonstrate how the LDC would have performed under the proposed incentive mechanism during each of the previous three years. Historic performance under the specific proposals will assist the Commission and Staff in fine tuning specific aspects of benchmarks, setting dead bands, and assessing the performance of experimental incentive proposals.</p>	<p>Summary information has been provided of the benefits to customers and to Avista Energy for the period September 1999 through September 2002 in Confidential Exhibit __ (RHG-5C).</p>
<p>9. Benchmarks that include a combination of market based indices should demonstrate the liquidity of each index. If it appears an LDC can exert market power and so influence the level of any such index, the LDC should include a proposal for how the company will temper that market power in calculating its incentive benchmark.</p>	<p>The indices used in the Benchmark Mechanism are for trading points that are very active and liquid. These indices are commonly used for pricing in the industry for both physical and financial transactions. No ability or opportunity to exert market power or influence exists under the Benchmark Mechanism.</p>
<p>10. The Commission should avoid establishing a one-size-fits-all incentive mechanism. Each LDC should be allowed to file an incentive mechanism that conforms with these policies, and meets the company's specific needs.</p>	<p>The Company has proposed an incentive mechanism that it believes best meets the utility's customer needs, while complying with the Commission's Policy Statement.</p>
<p>11. In special circumstances, the Commission may consider gas cost incentive mechanisms other than those based on externally generated benchmarks. However, other gas cost incentive mechanisms should conform generally with these policies. Requests for other incentive mechanisms should include an explanation why a company believes an alternative method is more appropriate to their circumstance than an external benchmark.</p>	<p>The commodity component of the Benchmark Mechanism is designed such that Avista Energy's performance is based on a comparison to an external benchmark of gas cost. (see pages 7-9 of Mr. Norwood's testimony (KON-3T))</p>

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Policy #		Utility Compliance
12.	The Commission should not consider narrowly focused incentive mechanisms, such as simply sharing capacity release revenue or off-system sales revenue. A narrowly focused approach provides too many opportunities for the incentive system to be gamed, thus failing to provide incentives to minimize gas costs.	The current Benchmark Mechanism is broadly focused, is designed to prevent the gaming or manipulation of results, and takes into consideration the entire assets of the utility for maximizing benefits to utility customers.
13.	Procedures associated with proposed incentive mechanisms should be tariffed to clearly establish both how fixed and variable components of the benchmark are calculated and how deviations from the benchmark will flow into rates. Providing clearly identified procedures in approved tariffs will help to minimize potential future controversies.	The procedures and calculations associated with the proposed Benchmark Mechanism are clearly outlined in Tariff Schedule 163 and flows through the current PGA deferral process to minimize potential future controversies.
14.	Each LDC--even if incentives are not proposed--should clearly tariff the procedures for setting its PGA and deferral rates in that company's next PGA/deferral rate filing. Providing clearly identified procedures will help to minimize potential future controversies.	The procedures and calculations associated with the proposed Benchmark Mechanism are clearly outlined in Tariff Schedule 163 and flow through the current PGA deferral process to minimize potential future controversies. The Company does not believe that Tariff 163 constitutes pre-approval of prudence issues by the Commission.
15.	Gas cost incentive mechanisms should not replace the Commission's ability to review the prudence of utility management actions in general rate proceeding or deferred gas cost filing.	The current Benchmark Mechanism continues to preserve the Commission's ability to review gas procurement operations to ensure that reliability of service is not compromised and that rates to customers are fair, just, and reasonable.