**BEFORE THE WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION**

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| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br><br>Complainant,<br><br>v.<br><br>AVISTA CORPORATION d/b/a AVISTA UTILITIES | DOCKET NO. UG-021584 |

**INITIAL BRIEF OF PUBLIC COUNSEL**

**WASHINGTON STATE ATTORNEY GENERAL'S OFFICE**

**DECEMBER 22, 2003**

## I. INTRODUCTION

1. The Public Counsel Section of the Washington State Attorney General's Office ("Public Counsel") respectfully requests that the Washington Utilities and Transportation Commission ("Commission") reject Avista Corporation's proposed gas purchasing benchmark mechanism ("mechanism") and order that the gas purchasing function be returned to Avista Utilities.

## II. BACKGROUND

2. The Commission first permitted Avista Corporation to implement a mechanism in September of 1999. Prior to that time Avista Utilities procured its own natural gas and performed the functions contained within the proposed mechanism (e.g. storage management, basin optimization, etc.). The mechanism was modified and then approved with an additional one year extension with a scheduled expiration date of March 31, 2003. The current proposed mechanism makes additional modifications and proposes an extension of the termination date to March 31, 2007. Exhibit 201, p. 8. Mr. Parvinen provides a description of the mechanism currently in effect, the mechanism proposed in the company's original filing, and the modifications further proposed by the company in its testimony in this docket. *Id.*, pp. 9-15.

## III. ARGUMENT

3. The company asserts that the burden of persuasion rests with Commission Staff and Public Counsel to demonstrate a compelling reason why the mechanism should not continue. Tr. 117, ll. 1-4. We respectfully disagree and believe that the burden of persuasion is upon Avista Corporation to demonstrate that the proposed mechanism is in the public interest and does not violate state laws regarding affiliate interest agreements. This is the first adjudicatory proceeding at the Commission examining the mechanism. Tr. 116, ll. 15-18. The company has failed to meets its burden in this proceeding and the proposed mechanism should be rejected.

4. Public Counsel recommends the Commission reject the company's proposal to modify and continue the mechanism and instead return the gas purchasing function to the utility. The


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proposed mechanism fails to establish a true "benchmark" against which Avista Energy's behavior can be measured. Exhibit 251C, p. 8, ll. 11-13. Avista Energy's performance of this function is not worth $900,000 per year, let alone one out of every five dollars of "benefit" accrued from certain actions. As the company said presciently in 1997:

> The challenge is to come up with fair benchmarks which can measure cost deviations resulting from actions over which the company has some control. The company believes it should be rewarded or penalized on its decisions, not simply because the market trends up or down. Exhibit 22, p. C-10.

Unfortunately, the proposed mechanism falls short of these laudable goals. The mechanism the company proposes in this docket is not fair, it does not measure cost deviations attributable to company actions, and it consistently rewards the company when the market simply performs in accord with market trends.

**A. The Proposed Benchmark Mechanism Should Be Rejected.**

5. This Commission should only approve a gas benchmark mechanism when it is presented with one that is fair, and only rewards decision making that does more than capitalize on market trends, as any prudent gas manager would do. Unfortunately, Avista Corporation has failed to present the Commission with such a mechanism. As discussed in testimony and at the hearings, the company's proposed mechanism constitutes a gas procurement strategy based upon three parts, or "Tiers." Tier I procurements are six to eighteen month advance purchases of 50% of expected demand. Tier II procurements are first of the month ("FOM") purchases of the remaining 50% of expected demand from the three gas basins the company can access (AECO (Canada), Sumas, and Rockies) based upon basin weightings determined by the company. As a result, 100% of Avista Utilities average gas load has no "benchmark" against which performance can be measured or that can either be beaten or fail to be beaten for purposes of determining an appropriate reward. Tr. 126, ll. 18-22. The proposed mechanism fails to establish a reasonable cost of gas against which performance can truly be measured. Ex 251C, p. 4, ll. 19-20.


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6. Tier III procurements cover the daily "swing" volumes necessary to meet demand that is outside the historically forecast, expected demand. Tier III procurements come in the form of either daily market purchases priced at the average daily price of all of Avista Energy's portfolio on that day, or from an "out of schedule" withdrawal of stored gas that is similarly priced. Exhibit 251C, p. 6. Avista Energy proposes a "synthetic schedule" for the use of natural gas storage, and deviations from this schedule create additional opportunities for Avista Energy to benefit. Tier I and II contain no reward opportunities for Avista Energy and are simply part of the larger gas purchasing strategy that could be executed by Avista Utilities as effectively as it can by Avista Energy. The question of improper rewards arises within Tier III.

7. Under the proposed mechanism Avista Energy will keep one dollar out of five (80:20 sharing) when its actions in meeting Tier III daily demand beat the various standards established by the proposed mechanism. As will be discussed below, it is Public Counsel's position that the standards established by the mechanism for Tier III inappropriately reward Avista Energy for simple, prudent decision making and for normative market behavior where the predictable actions of Avista Energy in response to market trends, and not the business acumen of Avista Energy, result in rewards to Avista Energy.

8. The proposed mechanism has five significant reward opportunities for Avista Energy in Tier III in addition to the proposed annual payment of $900,000 of ratepayer money. Under the proposed mechanism Avista Energy will be rewarded each time the following occurs:

1. When there is a positive difference between the first of the month price and Avista Energy's daily, average portfolio price,

2. When Avista Energy can execute transactions from the lowest cost basin above the basin weightings the company itself sets,[1]

3. When there is a positive difference between the average inventory cost of gas in storage and the FOM price when the company withdraws gas from storage,

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[1] The phrase "the company" is used in the context of decision making to reflect the apparent Strategic Oversight Group ("SOG") process. Mr. Gruber (AU) and Mr. D'Arienzo (AE) collectively make many of these decisions with Mr. Gruber as the apparent final arbiter. Tr. 245, ll. 8-15 and Tr. 352, ll. 14-17.


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4. When there is a positive difference between the forward price and the daily price Avista Energy is rewarded for releasing gas from storage outside the synthetic schedule, and

5. When there is a positive difference between the delivery point index price and the receipt point index price Avista Energy is rewarded for releasing transportation capacity or making an off-system sale bundled with transportation capacity. Exhibit 251C, p. 7.

Each of these circumstances are examples of where Avista Energy will be rewarded under the proposed mechanism for otherwise prudent decision making or where the mechanism is biased to assure returns based upon common market trends and not Avista Energy's business acumen.

**1. The proposed mechanism inappropriately rewards Avista Energy for market trends.**

9. The proposed mechanism is designed to reward Avista Energy according to relative changes between different market prices (FOM, daily index, basin prices, etc.). There is nothing discernible in the proposed mechanism that measures the cost deviations based upon company decision making, relying instead upon predictable changes in market prices that allow the company a greater assurance of reward and a reasonable assurance of avoiding losses, all to the detriment of ratepayers. The company has admitted that the index prices relied upon by the proposed mechanism are controlled by weather, customer demand and other factors which does not include the company's own actions. Tr. 131, ll. 2-12.

10. The proposed mechanism is structured in such a manner that Avista Energy repeatedly benefits from market trends. This is most clearly exemplified by the proposal in Tier III to provide a benefit to Avista Energy when there is a difference between the price of gas in storage and the FOM price at the time of withdrawal. With only transient exceptions, the price of natural gas has historically been higher in the winter than in the summer. Tr. 141, ll. 12-17. Gas is typically injected into storage in the summer and withdrawn for use in the winter. Avista Energy's decisions do not affect common market trends yet they claim a right to benefit as a result. Tr. 144, ll. 6-15.

11. Similarly, when there is a positive difference between the FOM price and Avista Energy's daily, average portfolio price, Avista Energy is rewarded under the proposed mechanism. The FOM is a forward price available at the first of the month and represents an index of actual trades as reported to the various reporting services. Tr. 124, ll. 5-16. Avista Energy's daily, average portfolio price is simply the average price of the gas it purchased on a given day. As the company itself stated in 1997, "it should be rewarded or penalized on its decisions, not simply because the market trends up or down." Exhibit 22, p. C-10. However, the company now also concedes that "it's hard to distinguish between differences that are caused by decisions made and differences caused by the market." Tr. 185, l. 16 to Tr. 186, l. 2. All too often the proposed mechanism rewards Avista Energy for the predictable actions of the market and not the actions of Avista Energy.

12. The company's own analysis determined that Avista Energy's efforts for Tier III are essentially indistinguishable from simply purchasing the same gas at the gas daily index. Tr. 128, ll. 13-22 and Tr. 394, ll. 17-20. In essence, all of the purported "benefits" of Avista Energy's actions and expertise resulted in an outcome indistinguishable from simple market purchases at the gas daily index - actions that Mr. Gruber or any prudent gas manager could take on behalf of Avista Utilities. The company has conceded that if Avista Utilities were performing the gas purchasing function that it would be exposed to the same market conditions and would purchase gas in a similar fashion. Tr. 308, ll. 2-21. There is no compelling policy rationale, factual or legal basis for rewarding Avista Energy for market trends instead of its own decision making. The difficulty of doing so is an inadequate excuse.

### 2. The proposed mechanism inappropriately rewards Avista Energy for prudent decision making.

13. As Mr. Gruber admits, the only rationale for rewarding Avista Energy for its actions when it is performing functions which he or any prudent gas manager could perform on behalf of Avista Utilities is "if they can get a better deal." Tr. 310, ll. 6-12. Mr. Gruber also concedes that


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this differential would be very difficult to measure. Tr. 310, l. 21 to Tr. 311, l. 13. To put it simply, rather than tackle the difficulties inherent in properly measuring the differential between the deal Mr. Gruber could do and the deal Mr. D'Arienzo could do, the company decided to simply seek rewards for Avista Energy any time it did a decent deal. Simpler, yes but equitable, no. Nor is it consistent with the Commission's policy statement and other principles which the company itself asserts it is complying with as is discussed in detail below. Ultimately, Avista Energy should be rewarded (if at all) only for its ability to manage around market movements and not for simple, rational actions in response to market signals which Avista Utilities itself could take on behalf of its customers. Tr. 171, l. 24 to Tr. 172, l. 3.

14. Public Counsel believes that the proper measure of an incentive mechanism regarding decision making is whether the proposal will provide benefits that the utility could not achieve on its own. Public Counsel would respectfully assert that this is not the case with the proposed mechanism. During his cross-examination Mr. D'Arienzo made it clear that his view is:

> "… what I'm suggesting is that I should be compensated for doing a good job, and that some of our abilities that our company has may be different than those of the Utility but that I should be compensated for the amount of risk and effort I put in as well as the value that I bring to the Utility and the core customers."

Tr. 38, l. 22 to 382, l. 3.

15. While Public Counsel may concur as a general matter that it is appropriate in a neutral business setting for Mr. D'Arienzo to seek compensation in the manner he describes, this is not the appropriate basis for compensation under a proposed gas purchasing mechanism. The standard the Commission should apply is whether Avista Energy can achieve a better result than Avista Utility, as a result of Avista Energy's expertise, and then any rewards should be derived from that differential or delta. Rewards should not be based upon standard market trends or simply prudent decision making. As Mr. Parvinen testified, Avista Energy has failed to demonstrate in this proceeding that Avista Energy is adding value and the record is replete with



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examples where Avista Utilities could achieve the same benefit simply by purchasing gas at the daily market price. Tr. 516, l. 12 to 517, l. 8.

16. With regard to the basin optimization element, it is clear that any prudent gas manager would seek to maximize the benefits that accrue from purchasing as much gas as possible from the lowest cost basin available. In fact, Avista Utilities was capturing this value well before the mechanism was originally put in place. Tr. 160, ll. 21-24 and 162, ll. 1-11. Doing so is not an action for which Avista Energy should get one dollar out of every five. Further, the use of biased basin weightings allows Avista Energy to improve the probability that it will receive a benefit. The more precise question to ask in this regard is to what degree does Mr. D'Arienzo on behalf of Avista Energy add value to basin optimization that Mr. Gruber cannot? While there have been repeated assertions regarding Avista Energy's ability to access the market, there is nothing in the record now before the Commission that demonstrates that Mr. Gruber would be unable to complete basin optimization transactions for the benefit of Avista Utility and its ratepayers in an equally effective fashion. The company has utterly failed to present any specific, credible evidence which would support a claim that Avista Energy can accrue X benefit in basin optimization in comparison to Y benefit which Avista Utilities could achieve. Mere general statements regarding market activity and volumes of transactions is insufficient to demonstrate that Avista Energy <u>in fact</u> has, can, and will achieve a greater benefit for Avista Utilities than Avista Utilities is capable of creating for itself.

17. Similarly, Avista Energy proposes that it be rewarded whenever it withdraws gas from storage for use by ratepayers.[2] Any prudent gas manager would utilize stored gas to meet daily peak demand when doing so is more economic than going to the daily market and when doing so does not jeopardize reliability over the heating season. What Avista Energy has failed to demonstrate is to what degree it adds value in a manner that Avista Utilities cannot. The

[2] The company proposes the reward either when the FOM price is greater than the inventory cost of the gas stored or if releasing gas outside of the synthetic schedule, when there is a difference between the daily and forward price.



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company has submitted no specific, credible evidence that Avista Energy's management of storage can accrue X value over the Y value that Avista Utilities would accrue were the management function to revert to the utility.

18. Finally, it is clear that as to many of the ultimate decisions regarding Tier III transactions that Mr. Gruber, as head of the company's SOG, has the final say in the decision of whether to pursue a given path. In essence, Avista Utilities, through Mr. Gruber, is already making the decisions for which Avista Energy would be rewarded under the proposed mechanism. Tr. 245, ll. 8-15 and Tr. 352, ll. 14-17. As Mr. Gruber stated, the utility would certainly do no worse a job than it had in the past, prior to the creation of the mechanism. Tr. 273, l. 23 to Tr. 274, l. 12 and Tr. 331, ll.2-7. It is clear that Mr. Gruber, or any prudent gas manger, can achieve a majority (if not all) of the "benefits" which the proposed mechanism would reward Avista Energy. For these reasons, the Commission should reject the proposed mechanism and revert the gas procurement function to the utility.

### 3. The proposed mechanism inappropriately rewards Avista Energy in a manner biased to assure returns.

19. Avista Energy appears to have carefully structured the proposed mechanism such that "heads shareholders win and tails ratepayers lose." Exhibit 251C, p. 8-12. The 80:20 sharing in the proposed mechanism assures Avista Energy one dollar of every five in virtually assured benefits while exposing Avista Energy to only 20% of substantially less probable costs. As Mr. Parvinen testified, there is in fact a zero probability of losses to Avista Energy from basin optimization transactions as they would never enter into such transactions. Tr. 513, ll. 6-12. As Ms. Elder discusses in her direct testimony, Avista Energy can take advantage of its structuring of basin weightings and other elements in Tier III to assure a high probability of reward while exposing itself to only a minor risk of cost. Exhibit 251C, pp. 8-12. Since the reward items in Tier III are biased in Avista Energy's favor, it is not exposed to the same degree of risk that 20% sharing might otherwise imply.


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20. Avista Energy conveniently ignores the relative risk that Avista Utilities would face in prudency reviews when weighing the relative merits of risk and reward. The 20% "risk" is not incremental and would be substituted by a less quantifiable (and arguably more "risky") risk associated with a disallowance in a prudence review. *Id.*, p. 14. In addition, the $900,000 annual fee proposed in the mechanism further shelters Avista Energy from its already low risk exposure. In assessing the relative risks and rewards this must be taken into account. Tr. 204, l. 24 to Tr. 205, l. 3. Thus, taken individually and collectively, the proposed mechanism allocates a low level of probability of Avista Energy being exposed to risks while allocating a high probability of reward. Public Counsel believes that this is inappropriate and far from "symmetrical." For these reasons the proposed mechanism should be rejected.

21. Avista's response to these criticisms is that there should be a "balance of reward and loss across the whole mechanism...[and] a balancing of the risks and rewards." Tr. 173, ll. 8-12. Public Counsel agrees completely with this sentiment, but respectfully asserts that the company's proposal does not come near meeting its assertions regarding the balancing of risk and reward. As Mr. Norwood conceded, there can be situations where the probability of receiving a reward is greater than the probability of incurring a loss, thus resulting in asymmetry. Tr. 174, ll. 17-24. As Chairwoman Showalter and Ms. Elder both identified, the critical and most challenging element in deciding the respective probabilities for reward or loss is in the setting of the benchmark. Tr. 202, ll. 12-15 and Exhibit 251C, p. 5, ll. 8-10. Fundamental to the individual and collective flaws in the proposed mechanism is the company's unwillingness to recognize that it has structured the mechanism in such a manner that it is assured of 20% of highly probable returns while being exposed to only 20% of very low probability costs. Tr. 177, ll. 10-15. Reward (or loss) should only be applicable where it is allocated to the exercise of expertise that goes beyond the market or what the utility can do for itself. The proposed mechanism's failure to achieve this is the principle reason for Public Counsel's objections.

### 4. The proposed mechanism is not in the public interest.

22. As the company has conceded, there are a number of ways a gas purchasing incentive mechanism can be structured. Tr. 170, ll. 6-8. In fact, the company has changed its own proposal over time, including within the course of this proceeding.

#### a. Gas purchases may not be prudent and prudence will be difficult to audit and determine by the Commission.

23. The proposed mechanism creates a structure that will make it virtually impossible for the Commission to determine the prudence of a given transaction. Avista Energy's use of "mark-to-market" accounting prevents the Commission from comparing a given transaction performed by Avista Energy on behalf of Avista Utilities to the market price on the day of the transaction as the company fails to keep such records. Exhibit 251C, p. 18. Avista Energy uses the mark-to-market accounting structure because, "Mark-to-market is the only way for us to value what our actual positions are, our whole business." Tr. 435, ll. 6-7. With all due respect to Mr. D'Arienzo, the Commission's concern in this regard should be the degree to which Avista Energy's actions on behalf of Avista Utility are auditable and not with the value of Avista Energy's "whole business."

24. The Commission will only be able to determine if Avista Energy's procurements for Avista Utilities were consistent with the terms of the proposed mechanism and not whether true benefits were achieved. Avista Energy will not engage in specific transactions that are allocated to Avista Utilities, are auditable, and can be compared to market prices on the day of any given transaction. Instead, Avista Energy's purchases and actions on behalf of Avista Utilities can only be compared against its own results on behalf of all its clients (average daily price of its portfolio). Exhibit 201, pp. 21-25.

25. The proposed mechanism contains no external "benchmark" based upon the market price of gas on a given day as the Commission defined that term in its policy statement, and thus


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cannot be adequately audited. As Mr. Parvinen stated,

> "… the crux of what has been the on-going problem, is identifying what it actually costs Avista Energy to serve Avista Utilities. Without knowing exactly what it costs Avista Energy to serve the Utility, we don't know whether customers have gotten a good deal or not." Tr. 497, ll. 20-25.

What Avista Energy is proposing here is simply a pricing plan with a series of rewards rather than a true "benchmark."

### b. Hedging activity by Avista Energy may be detrimental to ratepayers.

26. It will similarly be impossible for the Commission to determine whether Avista Energy's hedging activity has been beneficial to ratepayers. The proposed mechanism will allow the Commission to determine whether Avista Energy *believes* its conduct has been beneficial based upon the level of rewards it accrues. However, the answer to that particular question is predetermined by the structure of the proposed mechanism itself. As Chairwoman Showalter properly identified during the cross-examination of Mr. Gruber, the proper measure of this issue is the differential between the relative advantage of Avista Energy versus Avista Utilities performing this function. Tr. 325-326. Unfortunately, the proposed mechanism fails to measure this differential, which would in fact be the proper basis for determining any benefit that should accrue under the mechanism.

27. Mr. Gruber's response to the criticism that Avista Energy and Avista Utilities would have the same market position vis a vis purchasing hedges is to focus on the counter-parties which Avista Energy has access to. Tr. 323-324. While not stated explicitly, the implication of Mr. Gruber's statement is that Avista Energy would have a greater access to counter-parties or would be able to receive a better price than Avista Utilities. Tr. 324, ll. 10-21. Mr. Gruber himself raises the question of how counter parties view the risks of engaging with transactions with Avista Energy versus Avista Utilities. It is also clear that counter-party risk is something that Avista Energy is forced to spend significant time managing. Tr. 433, ll. 14-21. Arguably, Avista Utilities, as an investor owned utility with a regulated rate of return would have a lower risk


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profile than Avista Energy which is an unregulated trading company, despite its greater activity in the market in the view of potential counter-parties. Further, while the utility may have access to fewer potential counter-parties, those counter-parties are likely to have a lower risk profile themselves than some of those with whom Avista Energy transacts.

28. In addition, as Mr. Parvinen described, Avista Utilities' storage capacity provides a hedge on price volatility. Tr. 504, l. 23 to 505, l. 7. There is no persuasive evidence in this proceeding that Avista Energy can outperform Avista Utilities in its hedging activities. The inability of the Commission to effectively audit such conduct on the part of Avista Energy creates unacceptable risks for ratepayers.

### c. The proposed mechanism does not comport with the Commission's policy statement.

29. The proposed mechanism fails to satisfy guiding principles 1, 2, 3, 7, 12, and 15 from the Commission's policy statement in Docket Nos. UG-940778 and UG-970001. Exhibit 210 ("Policy Statement") and Exhibit 251C, p. 3. The company itself agrees that the Policy Statement "is still pretty good in terms of trying to develop a mechanism that does the right things." Tr. 185, ll. 11-13. And in virtually the next statement the company concedes that "it's hard to distinguish between differences that are caused by decisions made and differences caused by the market." Tr. 185, l. 16 to Tr. 186, l. 2. It is this very reason that makes the proposed mechanism unsupportable in our view. The rewards have been structured around market behavior rather than Avista Energy's decision making. While it is true that neither this nor any policy statement has the binding or preclusive effect a statute or agency rule would have, Public Counsel concurs with Avista witness Norwood that the Policy Statement still provides reasonable guidance. *Washington Education Assoc. v. Wash. State Public Disclosure Comm., et al.*, ____ P.3d ____, 1, 2003 WL 22909078, Docket No. 72877-1, (December 11, 2003).

30. As discussed in the Policy Statement, and during cross-examination of several witnesses, the proposed mechanism clearly fails the standards set by the Commission in its Policy


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Statement. Fundamentally, Avista Energy's proposed mechanism is not a "benchmark mechanism" at all as the Commission used that term in the Policy Statement. Instead, it is a gas purchasing and pricing strategy that offers Avista Energy a series of arbitrage opportunities based variously upon market trends and the actions any prudent gas manager would take.

31. First, the proposed mechanism fails to compare actual gas costs to an external benchmark. The Policy Statement is clear that companies should only be rewarded "based on performance relative to an external benchmark of market gas cost." Exhibit 210, guiding principle one, p. 2. Avista Energy's proposed mechanism fails to compare its performance to "an external benchmark of market gas cost" both because the company's use of mark-to-market accounting prevents doing so, as does the structure of the proposed mechanism.

32. The proposed mechanism also fails the second guiding principle established by the Commission in its Policy Statement, because total gas costs are not included in the benchmark. Instead of aggregating its proposed performance under the mechanism and determining its performance against market gas costs, Avista Energy has instead broken total gas costs down into discrete elements. Each has its own measure of performance, each with its own opportunity to benefit Avista Energy, and collectively lacks a total cost of gas against which to measure Avista Energy's performance. As the Commission presciently observed in 1997, failure to look at total costs creates opportunities for gaming. As discussed with Mr. Norwood, the opportunity for gaming exists in the proposed benchmark mechanism and the single hypothetical example used in cross examination was but one of many possible scenarios wherein the proposed mechanism can be "gamed" to Avista Energy's advantage. Tr. 188-189. As argued above, the structure of the proposed mechanism is inherently "gamed" in that it offers Avista Energy a high probability of reward while only placing it at a low probability of incurring costs. Exhibit 210, p. 2.

33. Similarly, the proposed mechanism fails to meet the criteria of the third guiding principle of the Policy Statement. The third guiding principle states: "Incentive mechanisms should be


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simple to understand and apply, avoiding complex calculations which could lead to disputes or gaming." The proposed mechanism fails to meet this criteria as it is quite complex, is structurally "gamed," and offers multiple opportunities to be gamed in its execution. *Id.*

34. Guiding principle four indicates that a proposed mechanism should reflect the market and the company should be rewarded when its performance is better than the market. *Id.* Yet the company concedes that Tiers I and II are bought directly at market price and Avista Energy's performance of Tier III has in practice been indistinguishable from the daily market price. Tr. 128, ll. 13-22 and Tr. 171, l. 24 to Tr. 172, l. 3. The proposed mechanism clearly fails to meet the goals of the fourth guiding principle from the Policy Statement.

35. While the proposed mechanism includes opportunities for risk and reward, it fails the fifth guiding principle because the probability of incurring those costs or receiving those rewards is not symmetrical as discussed above. *Id.*

36. The proposed mechanism fails the seventh guiding principle because it fails to contain an evaluation mechanism that would allow the Commission to audit its performance against the cost of market gas. *Id.*

37. Guiding principle twelve expresses the concern that a narrowly focused approach leaves a mechanism open to gaming opportunities. Exhibit 210, p. 3. As discussed with Mr. Norwood, any mechanism that is comprised of smaller segments creates a risk that each smaller segment has an opportunity for improper reward through gaming. Tr. 187-192. Because the proposed mechanism does not take an aggregated approach where rewards are only achieved when there is a net benefit directly attributable to management expertise, there are multiple opportunities for gaming the proposed mechanism whether through under-forecast loads, inappropriately set basin weightings or other means.

38. Guiding Principle fifteen suggests that a mechanism should not impair the Commission's ability to conduct prudence reviews. Exhibit 210, p.4. As discussed previously, the structure of

the proposed mechanism will severely, and perhaps fatally, impair the Commission's ability to determine prudence in a subsequent proceeding.

### d. The affiliate relationship between Avista Energy and Avista Utilities raises significant legal and public policy concerns.

39. Affiliate relationships have long been a concern of legislators and utility regulators. Chapter 80.16 RCW. Historically, affiliate relationships with un-regulated subsidiaries of the utility or of a parent company have been a frequent vehicle for such abuse. This is the basis for the very careful scrutiny which Public Counsel believes is necessary in this matter. Avista Energy is an unregulated affiliate of Avista Utilities. Exhibit 201, p. 16. Given the mechanism's failure to equitably balance risk and reward, its reward of the unregulated affiliate for simply prudent behavior, and its structural bias towards rewarding the affiliate, Avista Energy, Public Counsel cannot support the mechanism as proposed.

40. In evaluating affiliate interest transaction the Commission has historically applied the "lower of cost or market" standard. *Id.*, pp. 18-20. The inability of the Commission to adequately audit Avista Energy's transactions on behalf of Avista Utilities and to apply the lower of cost or market standard to these transactions is also fundamental to Public Counsel's concerns about the nature of the proposed mechanism.

41. As Mr. Parvinen aptly described, the rationale for applying the "lower of cost or market" standard to affiliated relationships is to have some assurance that that the utility is "… not subsidizing that non-regulated entity." Tr. 517, ll. 15-25. The Chairwoman correctly identifies that it appears from the record now before the Commission that the Commission cannot assure that the Utility is receiving the lower of cost or market from the proposal now before it. Tr. 521, ll. 11-23. We believe this is a legally sufficient basis for rejection of the proposed mechanism.



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## IV. CONCLUSION

42. Public Counsel recommends rejection of Avista Corporation's proposed mechanism. The gas purchasing function should be reverted to Avista Utility with all deliberate speed.

RESPECTIFULLY SUBMITTED this 22nd day of December, 2003.

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