I. SUMMARY

1 Avista[1] is seeking Commission approval of what Avista calls a gas cost "Benchmark Mechanism." The Benchmark Mechanism is implemented by a tariff that prescribes the formula for calculating the price ratepayers are charged for the cost of gas.

2 Avista's proposed Mechanism suffers from many of the flaws that have plagued it since 1999, when it began as a three-year experiment. Avista has failed to correct those flaws.

3 First, Avista Utilities still cannot prove the reasonableness of its transactions with Avista Energy under the Benchmark Mechanism. Those are affiliated interest transactions, subject to the "lower of cost or market" standard. Avista cannot provide the actual market value of the services it receives from Avista Energy. Avista also cannot provide Avista Energy's actual cost of supplying the gas. (*See* Part IV.A, ¶¶ 26-52 below.)[2] As a result, the Commission cannot determine the reasonableness of the transactions, and it should not approve the Mechanism for that reason.

4 Second, the Benchmark Mechanism is poorly structured. Proper benchmarks reward the utility for better than average performance, based on factors it controls, not

[1] In this brief, the regulated gas utility business of Avista Corporation is referred to either by its trade name: "Avista Utilities," or the "Utility." The term "Avista" or "Company" refers to Avista Corporation as a whole. "Avista Energy" refers to Avista Energy, Inc.

[2] Even if Avista Energy were not an affiliated interest of Avista Utilities, the agency contract between them is not at arm's length. (Parvinen, Exh. 201-T at 16:17 to 17:1). The Commission applies the same "lower of cost or market" standard in that context. *See* ¶ 27 at page 9, and footnote 8 at page 11, below.

simply because the market is higher or lower. The Benchmark Mechanism fails this common sense test. It rewards Avista Energy for average, and even below average performance, and it can generate rewards and penalties just because the market trends higher or lower. (*See* Part IV.B, ¶¶ 53-79 below.)

5 Third, Avista has not proven it can operate a benchmark mechanism to achieve the lowest cost of gas to ratepayers. Avista Energy had a choice of using the Mechanism to make deals for its sole benefit, or deals that benefited customers as well. Avista Energy elected to make deals for its own benefit, and Avista Utilities did nothing to stop it. (*See* Part IV.C, ¶¶ 80-100 below.) There is every reason to believe similar conduct will occur under the proposed Mechanism, in ways yet to be imagined. The Commission should not approve the Mechanism for that reason.

6 Fourth, the Benchmark Mechanism fails to comply with the Commission's Policy Statement on gas incentive mechanisms, for many of the same reasons outlined above. (*See* Part IV.D, ¶¶ 101-110 below.)

7 Finally, even if Avista could cure the foregoing deficiencies, it has not proven ratepayers are getting a good deal under the Mechanism. Avista failed to measure all costs and benefits involved. But even under many conservative assumptions that favor Avista, Staff demonstrated ratepayers would be better off by about $1.6 million annually, if the gas procurement function returned to the Utility. (*See* Part IV.E, ¶¶ 111-164 below.)

8 For the foregoing reasons, the Commission should allow the Benchmark Mechanism to expire.[3]

II. BURDEN OF PROOF

A. Avista Bears the Burden of Proof

9 Avista bears the burden of proving its proposed Benchmark Mechanism tariff is just and reasonable, and the reasonableness of its affiliated interest transactions. RCW 80.04.130(2), RCW 80.16.030.

B. Other Parties Do Not Have to Provide "Compelling Reasons" in Order for the Mechanism to End

10 Avista wants to require other parties to prove "compelling reasons" for discontinuing the Mechanism. (Norwood, TR. 117:1-4, Exh. 3-T at 3:16-17 and at 15:23-24.) This violates RCW 80.04.130(2) and RCW 80.16.030 because it improperly shifts the burden of proof to other parties, and it imposes a very stringent proof standard that has no basis in the statute. The Commission should reject Avista's theory on burden of proof and apply the statute as written.

III. FACTS

A. Historical Context of the Benchmark Mechanism

11 By the mid-1990s, Avista had identified changes that were occurring in wholesale gas markets, mostly due to federal deregulation. (*E.g.,* Exh. 22, Avista's 1997

[3] Staff recommended three alternatives short of canceling the Mechanism. (Parvinen, Exh. 201-T at 48:16 to 60:9). Because each of these alternative requires Avista's acceptance, and Avista opposed all three (*e.g.*, Norwood, Exh. 103-T at 16:3 to 17:23), Staff will not address these alternatives in this brief.

IRP at C-5 to C-10.) By that time, Avista was well aware of its ability to take economic advantage of its storage and transportation assets, as well as the three gas supply basins from which it buys gas. (*Id.* at 6-7: "WWP Summary," and at C-5 to C-10.) Avista also recognized the operating efficiencies it enjoys by combining loads from the three jurisdictions it serves. (*Id.* at C-5 and Norwood, TR. 165:16 to 166:8.)

12 Very favorable results flowed to the Utility as a result of its early management of these changes in wholesale gas markets: Capacity release revenues expanded rapidly, and off-system sales alone were in the $5 million to $13 million range annually. (*Id.* at C-5, C-8 and C-9.) All of this was accomplished without any help from Avista Energy. (Norwood, TR. 161:25 to 162:11.)

13 In this context, the Benchmark Mechanism went into effect in September 1999, as an experiment. (Exh. 203 at 1, last ¶, and Norwood, TR. 116:12-14 and 117:13-15.)[4] Since then, Avista Utilities has shared with its affiliate, Avista Energy, the revenues from capacity release and off-system sales, and all the other gas supply-related benefits Avista Utilities enjoyed.

[4] The initial Benchmark Mechanism tariff had an expiration date of March 31, 2002, which was later extended to March 31, 2003. (Parvinen, Exh. 201-T at 8:5-8). The suspension order in this docket permitted the Mechanism to remain in effect until January 29, 2004. (Complaint and Order Suspending Tariff Revisions at 3, ¶ 12 (January 29, 2003)). From the start of the Mechanism to date, the Commission has not issued any order approving the Mechanism. The first evidentiary hearing on the Mechanism was in this docket. (Norwood, TR. 116:15-25).

B. The Proposed Benchmark Mechanism[5]

14 The proposed Benchmark Mechanism is set forth in Avista's Tariff Schedule 163. (Exh. 152.) The tariff prescribes in great detail the procedures for determining the price of gas Avista Utilities obtains from Avista Energy. The price of gas computed under that tariff is tracked through to retail rates under Schedule 155, Avista's purchased gas adjustment tariff.

15 There are four components to the proposed Mechanism: The Commodity Component, the Storage Component, the Transportation Component, and the Basin Optimization Component.

1. Commodity Component

16 The Commodity Component contains three "tiers," called Tier 1, Tier 2 and Tier 3. These three tiers represent the gas needed to serve the Utility's average daily load, plus the gas needed for daily load balancing, to the extent the Utility's actual load differs from that average. (Parvinen, Exh. 201-T at 14:17 to 15:3.) The Commodity Component accounts for $58 million of the Utility's total $76.3 million annual gas cost for Washington (Norwood, Exh. 2 at 1.)

17 For purposes of Tier 1 and Tier 2, the Mechanism calculates Avista's average daily load using the average of Avista's last five years' actual loads. (Norwood, TR.

[5] The Mechanism has been revised since its inception. We will describe the differences between the various versions of the Mechanism as they relate to the issues presented. For a more complete description of the changes, *see* Parvinen, Exh. 201-T at 8-15.

218:2-10.) Tier 1 and Tier 2 gas comprise 100 percent of Avista Utilities' average daily load, measured in this way. That load is secured through the use of hedged contracts and storage to fix the price of the gas (Tier 1), and through purchases made at the First of the Month (FOM) index (Tier 2). (Norwood, TR. 119:6-24.)

18 Tier 3 is gas that is used to balance the daily supply and demand on the Utility's system. If the Utility's actual load on a particular day exceeds (or is less than) the calculated average, Avista Energy would buy (or sell) gas, respectively, to meet the daily load. (Norwood, TR. 127:2-12.)

19 Tiers 1 and 2 have no benchmark for Avista Energy to meet or beat. (Norwood, TR. 128:19-22.) The Tier 3 benchmark is the First of the Month (FOM) index. (Norwood, TR. 127:13-15.) Avista Energy's Tier 3 performance has been just average, essentially the same as if Avista Energy had transacted at the Gas Daily index. (Norwood, Exh. 3-T at 12:12-15 and TR. 128:13-18.) The Gas Daily index reports the average of all trades on a particular day. (Norwood, TR. 128:7-18, Gruber, TR. 265:9-20.) So, on average, Avista Energy has been unable to do any better (or worse) than the average trader in the same daily market.

2. Storage Component

20 Avista owns part of a gas storage facility in Washington at Jackson Prairie. (Parvinen, Exh. 201-T at 7:10-12.) Under the Storage Component, the Mechanism prices gas in storage by using a "synthetic schedule." In general, this schedule prescribes that

Avista Energy injects gas into storage in the summer (when prices typically are lower), and withdraws the gas from storage in the winter (when prices typically are higher.) (Norwood, TR. 140:19 to 141:17.)

21 The proposed Mechanism requires Avista to use the FOM index to price gas at the time it is injected into storage, and to use the average inventory price to price gas at the time it is withdrawn from storage. (Norwood, TR. 141:21 to 142:13.) If the difference between the FOM index and the average inventory price is a net cost, Avista Energy pays 20%, and the ratepayers pay 80%. If the difference is a net benefit (which is typical because winter prices are typically higher than summer prices), Avista Energy gets 20% of that benefit, and ratepayers get 80%. (Norwood, TR. 142:14-23.)

3. Transportation Component

22 The Transportation Component includes capacity release and off-system sales transactions. Customers are charged for all transportation costs, and then they are credited for any benefits Avista Energy achieves through capacity release and off-system sales transactions. Avista proposes $3 million as the annual guaranteed level of capacity release/off-systems sales revenues, with a sharing beyond the $3 million threshold of 80% to ratepayers, and 20% to Avista Energy. (Parvinen, Exh. 201-T at 15:15-19.)

4. Basin Optimization Component

23 Avista can purchase gas at three basins: AECO, Rockies and Sumas. (Parvinen, Exh. 201-T at 6:12 to 7:9, and Exh. 202.) The proposed Mechanism requires Avista to establish "basin weightings" by the first of February each year, effective the following November. The basin weightings dictate the percentage of gas that is purchased at each basin, for purposes of pricing gas under the Mechanism. (Exh. 152 at 1-2, Definition #1 and Norwood, TR. 145:22 to 148:17.)

24 The basin weightings do not dictate how Avista Energy actually buys the gas. On a daily basis, Avista Energy has the flexibility to purchase gas at the cheapest of the three basins, subject to capacity restrictions that may exist at a basin, but not subject to the Mechanism's basin weightings. (*Id.*, and Norwood, TR. 148:24 to 149:13.)

25 In the Basin Optimization Component, Avista Energy benefits by shifting gas to be purchased under the Mechanism-prescribed basin weightings to the cheapest basin. Avista proposes to share these benefits 80% to customers, and 20% to Avista Energy. (Norwood, Exh. 1-T at 5:4-7, TR. 148:24 to 149:13.)

IV. DISCUSSION OF THE ISSUES

A. The Benchmark Mechanism Should Not Be Approved Because Avista Has Not Passed the Cross-Subsidy Test for its Affiliated Interest Transactions

1. Background

26 Under the Agency Agreement (Exh. 204), Avista Utilities has assigned its gas procurement function to Avista Energy. The Agency Agreement is very broad in scope.

It covers all gas purchases for Avista's retail gas customers, valued at around $76.3 million annually in Washington alone. (Norwood, TR. 118:1-13 and Exh. 2 at 1.) The Agency Agreement gives Avista Energy the right to manage all of Avista Utilities' "supply, transportation and storage contracts" (Exh. 204 at 3-4, § III, ¶¶ A and B), which covers all of the Utility's supply, transportation and storage assets, including the Jackson Prairie and Plymouth LNG storage facilities.

27 Avista Utilities and Avista Energy have common ownership and are managed under the same Chief Executive Officer: Mr. Gary Ely. (Parvinen, Exh. 201-T at 16:6-11.) Accordingly, the Agency Agreement is not an arm's length transaction. As Staff testified, this is "the single most problematic aspect of the Mechanism …" (*Id.* at 16:12 to 17:1 and 18:1-6.)

28 Staff highlighted this important issue in its suspension memo (Exh. 203 at 4-5), and provided extensive direct testimony on it as well. (Parvinen, Exh. 201-T at 16-30.) Avista mostly dodged the issue in its case. The Commission should address this issue, and resolve it against Avista.

2. Avista Energy is an Affiliated Interest of Avista Utilities

29 Avista Corporation operates its regulated electric and gas business under the trade name "Avista Utilities." Avista Corporation owns Avista Capital, Inc., which in turn owns Avista Energy, Inc. (Parvinen, Exh. 201-T at 16:8-11.)

30 The Commission's affiliated interest statute defines an affiliated interest mostly in terms of a firm that owns a portion of the utility's voting securities. RCW 80.16.010. Because Avista Energy does not own any shares in Avista Utilities, most of the definitions in RCW 80.16.010 do not apply.

31 However, RCW 80.16.010 also defines an affiliated interest as "every corporation or person with which the public service company has a management or service contract." The contract between Avista Utilities and Avista Energy fits this definition in both form and substance. As to form, the contract describes itself as a "management" contract. (Exh. 204 at 1.) As to substance, the contract "gives Avista Energy the right to manage all of the pipeline capacity rights Avista Utilities has." (Norwood, TR. 136:1-6. *See also* D'Arienzo, TR. 407:24 to 408:12.)

32 Accordingly, Avista Energy is an affiliated interest of Avista Utilities for purposes of Chapter 80.16 RCW.[6]

3. The Commission Uses the "Lower of Cost or Market" Standard to Protect Ratepayers

33 When a regulated utility like Avista Utilities elects to do business with its affiliate, rather than the competitive marketplace, unique problems confront the regulator. Chapter 80.16 RCW was enacted to protect ratepayers from cross-subsidizing

[6] This conclusion is based on the plain meaning of RCW 80.16.010. We have located no Commission order interpreting the term "management or service contract" in RCW 80.16.010, nor any order from another agency from another jurisdiction interpreting a similar statute.

the affiliates of regulated utilities. The Commission applies the "lower of cost or market" standard to determine the reasonableness of affiliated interest transactions:

> In Washington State, the Commission has consistently used RCW 80.16.030 to protect ratepayers from possible harm from affiliated transactions. The regulated company bears the burden of demonstrating that the payment is reasonable in amount; if it does not do so, or if it does not show the cost to that affiliate of rendering service, the Commission is instructed to disallow payment. The standard for a reasonable price is the lower of the competitive market price or the affiliate's cost plus a fair return.

Utilities & Transp. Comm'n, v. US WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supp. Order at 54 (April 11, 1996)(footnotes omitted.)[7]

34 As Staff put it:

> … here we have an affiliate providing a service contract for its affiliate. We have Avista Energy, a non-arm's length transaction, essentially, with Avista Utilities. That needs to be evaluated under a lower of cost or market standard to show that customers are paying for … the appropriate value. In other words, not subsidizing the nonregulated entity.

(Parvinen, TR. 517:18-25.)[8]

35 The Supreme Court recognized the dangers inherent in affiliated interest transactions in *Western Distributing Co. v. Public Service Comm'n of Kansas*, 285 U.S. 119, 52 S. Ct. 283, 76 L. Ed. 655 (1932)("*Western*".) In that case, Western Distributing Co. ("Western") was a natural gas distribution utility operating in the state of Kansas. In

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[7] *See also*, *e.g.*, *Utilities & Transp. Comm'n*, *v. Washington Natural Gas Co.*, Docket Nos. UG-911236/UG-911270, Third Supp. Order at 6 (Sept. 28, 1992).

[8] Even assuming Avista Energy is not an affiliated interest of Avista Utilities, the Commission has adopted the same "lower of cost or market" standard when evaluating the non-arm's length transactions between a utility and its subsidiary. *E.g., Utilities & Transp. Comm'n, v. The Washington Water Power Co.,* Cause No. U-82-10 and U-82-11, Second Supp. Order at 26-30 (December 29, 1982).

1923, an unaffiliated company named Cities Service Gas Co. sold natural gas to Western at a price of 40-cents per mcf. Later, Cities Service Gas Co. and Western became affiliated through common ownership.

36 Western then filed a rate case, and sought to recover the cost of gas it purchased from Cities Service Gas Co. at the very same 40-cent/mcf price it had been charged prior to affiliation. Nonetheless, the Kansas commission insisted on inquiring into the reasonableness of the 40-cent wholesale rate. When Western provided no information on that issue, the commission dismissed, and Western appealed.

37 Western challenged the commission's right to inquire into the 40-cent rate because no other gas source was available, no lower price was available, the 40-cent price was the same price charged unaffiliated buyers, and the same rate was being charged by another, unaffiliated pipe line to another customer. 285 U.S. at 125-26. In effect, the utility was contending the ratepayers were no worse off before affiliation than after.

38 The Supreme Court held Western's proof legally insufficient:

> Where, however, the [wholesaler and retailer] constitute but a single interest, and involve the embarkation of the total capital in what is in effect one enterprise, the elements of double profit and of the reasonableness of inter-company charges must necessarily be the subject of inquiry and scrutiny before the question as to the lawfulness of the retail rate based thereon can be satisfactorily answered.

285 U.S. at 126.

39 Accordingly, the Court upheld the Kansas commission's right to inquire into the 40-cent rate and determine the appropriate charge for ratepayers to pay through rates.

40 This case shows that just because an affiliate may be charging the utility a "market rate," that is insufficient proof of the reasonableness of the utility's payment to its affiliate. The issue of cross-subsidy (called "double profit" by the Court in *Western*) must be addressed.

41 Therefore, Avista Utilities must prove the reasonableness of its purchases of gas from Avista Energy, and in doing so, it must demonstrate Avista Energy's cost of providing that gas. The "market price" is not sufficient, nor is any price generated under a formula such as the Benchmark Mechanism.

4. Avista Energy Cannot Provide Either the Cost or the Market Price of the Gas and Services It Sells to Avista Utilities Under the Benchmark Mechanism

42 Avista cannot comply with the "lower of cost or market" standard. The Agency Agreement was not competitively bid, so the market price of the services Avista Energy provides to Avista Utilities cannot be determined. (Parvinen, Exh. 201-T at 20:21 to 21:10.) Moreover, because Avista Energy does not track its actual revenues and costs on a per therm basis, it is impossible to know the actual cost of the gas Avista Energy sells to Avista Utilities. (*Id.* at 24:4 to 25:10.)

43 The difficulty in determining Avista Energy's cost of gas is exacerbated by the fact that Avista Utilities' gas load is managed as part of Avista Energy's total gas

portfolio. This means that Avista Energy buys and sells gas on a daily basis to balance its overall load, which includes the Utility's load. All of these activities affect the average actual cost Avista Energy incurs to provide gas to the Utility and its customers. (*E.g.*, Parvinen, Exh. 201-T at 21:12 to 22:13.)

44 Avista's position is that the cost of gas to Avista Energy is reflected in the contracts or invoices for gas Tier 1 and Tier 2, and in the invoices or spreadsheets for other transactions. (*E.g.* Norwood, Exh. 3-T at 9:13 to 10:12 and TR. 139:14-18; Gruber, Exh. 53-T at 14:17 to 15:2; D'Arienzo, Exh. 101-T at 6:15-19 and TR. 392:6-22.)

45 The facts contradict Avista's position. Indeed, there is not a single component within the proposed Mechanism that prices or measures gas at Avista Energy's cost. For example, in Tier 1 and Tier 2, the Mechanism only imputes a price calculated pursuant to certain contracts. But those contracts are only the starting point of Avista Energy's management of Tier 1 and Tier 2 loads. Avista Energy's day-to-day management of those loads affects the actual cost of the gas Avista Energy supplies to Avista Utilities. As Staff explained:

> Avista Energy operates on a total gas supply portfolio basis. … Avista Energy looks at its total daily load requirements and its gas portfolio to meet those total requirements, and then enters into daily purchases or sales as necessary to balance its total daily load requirements. … Gas within Avista Energy's portfolio (including the supplies earmarked as the Utility's) can be bought and sold at the same point, or delivered to points on or off the Utility's distribution system. … All of these activities affect the average cost of each therm used to serve the Utility's customers.

(Parvinen, Exh. 201-T at 21:17 to 22:11. *See also*, Exh. 206.)

46 Avista did not rebut this testimony, choosing instead to characterize Staff's concern as "immaterial" because, according to Avista, that concern applies only to the relatively small volumes of gas in Tier 3. (Norwood, Exh. 3-T at 12:3-12.) Avista is correct about one thing: Tier 3 gas is not priced at Avista Energy's actual cost, nor is Avista's actual cost documented:

> [t]he actual therms used by Avista Energy to balance the daily load volatility for the utility will not be traced back to specific purchases for the utility …

(Norwood, Exh. 3-T at 10:3-5.) But Avista's testimony otherwise misses the mark, because Staff explicitly stated its concern applies to all tiers, not just Tier 3. (Parvinen, Exh. 201-T at 23:1-3 and at 27:5-8.)

47 Indeed, Avista also agreed it does not track actual costs or revenues in the Transportation Component. Initially, Avista relied on Exhibit 104 in an attempt to prove the contrary. (D'Arienzo, Exh. 102-T at 3:13-20, TR. 369:8-23.) However, on cross-examination, Avista conceded Exhibit 104 reported neither the actual revenue Avista Energy received, nor Avista Energy's cost of the gas being sold off-system. (D'Arienzo, TR. 373:6-17.) Obviously, without Avista Energy's actual costs or revenues from these transactions, the "cost to the affiliate" (*i.e.,* the cost to Avista Energy) cannot be determined.

48 Similarly, the gas Avista Energy procures under the Storage Component of the proposed Mechanism is priced at First of the Month index prices, not what it actually

costs Avista Energy to buy the gas that actually gets injected into storage. (*See* ¶¶ 20-21 above.)

49 Finally, transactions in the Basin Optimization Component are priced at the difference between basin indices, not at Avista Energy's actual revenues and costs. (*See* Norwood, Exh. 5, Basin Optimization Section.)

50 In sum, Avista Energy's actual cost of the gas that serves the Utility's customers is not reflected in any price generated by the Mechanism, nor is it reflected in any document Avista maintains under the Mechanism.

5. Conclusions on Affiliated Interest Issues

51 Chapter 80.16 RCW was enacted to protect ratepayers from cross-subsidizing the operations of a utility's affiliate. Ratepayers are entitled to that protection. The Benchmark Mechanism cannot provide that protection. The structure of the proposed Benchmark Mechanism, the manner in which it is to be operated, and the records maintained by Avista do not permit the Commission to determine either the market price or the actual cost of the gas and services Avista Energy supplies to Avista Utilities.

52 Because Avista cannot provide the information necessary to pass the Commission's cross-subsidy test, the Benchmark Mechanism should be discontinued.

B. The Benchmark Mechanism is Structurally Unsound. It Rewards Avista Energy For Average, and Even Below Average Performance, in Circumstances Which Avista Energy Does Not Control

1. Background

53 The Benchmark Mechanism is structurally unsound because it contains inadequate benchmarks. The principles are not in dispute. Staff and Public Counsel agree with Avista's statement that "a benchmark is an objective standard against which the utility's performance is measured." (Norwood, TR. 118:14-17. *See* Elder Exh. 251-T at 4:11-13.)[9] Staff and Public Counsel also agree with Avista's statement that a benchmark should "measure cost deviations resulting from decisions and actions over which the company has some control. The [Utility] should be rewarded or penalized on its decisions, not simply because the market trends up or down." (Exh. 22, Avista's 1997 IRP at C-10; Exh. 23, Avista's 2000 IRP at C-4; Avista's Draft 2003 IRP at C-4.[10] *See* Elder, Exh. 251-T at 5:10-15.)

54 As we demonstrate below, no part of the proposed Benchmark Mechanism satisfies these common sense concepts of a benchmark.

[9] This concept of a "benchmark" is consistent with the common sense of the term: "a standard or point of reference in measuring or judging quality, value, etc." Webster's New World Dictionary (2nd College Ed. 1976).

[10] The excerpt of Avista's 2003 Draft IRP in Exhibit 24 does not contain the material quoted. However, the Commission took official notice of the entire text of Avista's 2003 Draft IRP. (TR. 158:25 to 159:7).

2. Commodity Component

55 Tier 1 and Tier 2 of the Commodity Component have no benchmarks at all, in the true sense of that term. Though Avista calls the prices generated under Tier 1 and Tier 2 "benchmarks" (*e.g.* Norwood, Exh. 12, 2nd page, last ¶), there are no means under the Mechanism for Avista Energy to do better or worse than these prices:

> Q: Okay. And for that, 100% of Avista's average estimate of its average gas load [the estimated loads in Tier 1 and Tier 2], there is no benchmark that AE can either beat or fail to meet; is that correct?
>
> A: For those estimates, that's correct

(Norwood, TR. 126:18-22)(*See* Norwood, TR. 120:10 to 126:22 for the complete cross-examination of Avista on this point.)

56 In other words, for the bulk of the gas Avista procures under the proposed Mechanism, there are no standards for measuring the quality of the purchasing decisions Avista Energy has made. The Mechanism measures only the results of those decisions, which are subject to neither reward nor penalty.

57 In Tier 3, there is a benchmark of sorts: The FOM index. Under this benchmark, Avista Energy is rewarded in Tier 3 if it buys gas in that tier at a daily price less than the FOM index, or sells gas at a price greater than the FOM index. In practice, however, Avista Energy's daily purchases and sales have been the same as if it had simply purchased or sold gas at the Gas Daily index. (Norwood, Exh. 3-T at 12:12-15 and TR. 128:13-18.) As Avista testified:

Q: So on average, Avista Energy has not been able to beat the gas daily index price for Tier 3; correct?

A: That's correct.

(Norwood, TR. 128:19-22.)

58 The Gas Daily Index averages all transactions of all market participants for the day. (Gruber, TR. 265:9-15.) Thus, in Tier 3, Avista Energy has performed no better than the average trader in the daily market. Yet the proposed Mechanism rewards Avista Energy for being average, so long as the price it gets beats the FOM index.

59 By the same token, the Mechanism can penalize Avista Energy for above average performance in Tier 3. For example, assume Avista Energy makes a Tier 3 purchase at a price lower (*i.e.*, better) than the average trade that day. Despite that better than average performance, the proposed Mechanism forces Avista Energy to share a cost, not a benefit, if that price is higher than the price the FOM index happens to produce.

60 In sum, the Tier 3 incentive is poorly conceived for three reasons. First, it rewards Avista Energy for an average job, not a good job, contrary to what Avista testified is appropriate. (Norwood, TR. 261:5-8.) Second, it violates the common sense concept that a benchmark should neither reward nor penalize a company "simply because the market trends up or down." (*See* ¶ 53 above.) Third, it can penalize Avista Energy when Avista Energy performs better than average. Accordingly, the benchmark in Tier 3 is inappropriate and should not be approved.

3. Storage Component

61 The Storage Component of the Mechanism suffers from flaws similar to those in Tier 3. As we explained above, the "synthetic" schedule calls for Avista Energy to inject gas into storage in the summer and withdraw it from storage in the winter. (*See* ¶ 20 above.) Avista Energy has no control over this winter/summer price differential, but nonetheless, the Mechanism prescribes a reward whenever summer prices are lower than winter prices. (Norwood, TR. 144:10-15, 143:20-25 to 144:9.)

62 Put another way, because summer prices typically are lower than winter prices, Avista Energy can get a reward for simply following the predetermined "synthetic" schedule of storage injections and withdrawals. (Norwood, TR. 144:10-15.) Avista Energy does not need to produce above average performance to get a reward under the Storage Component.

63 The Storage Component benchmark is as poorly structured on the penalty side as the reward side, because it can penalize Avista Energy for good performance, if the market shifts. As Avista explained:

> A: [This year, the] price in the winter is actually lower than in the summer months, so actually, with this mechanism in place, Avista Energy would actually be absorbing a portion of that difference [*i.e.,* the difference between average inventory price and FOM index price at the time of withdrawal].
> …
> Q: And it didn't cause that difference, did it, because it's a function of the …
>
> A: It's driven primarily by the market; that's true.

(Norwood, TR. 143:25 to 144:9.)

64 Thus, Avista Energy can get a reward (or a penalty) not for better than average decision-making, but simply because market prices trend up (or down) in the winter, relative to summer prices. This benchmark structure lacks common sense because Avista Energy does not create the summer/winter price differential, so it should neither be rewarded nor penalized if such a differential materializes.[11] (Elder Exh. 251-T at 9:20 to 10:14.)

65 Moreover, the risk of Avista Energy achieving or not achieving a benefit is not symmetrical in the Storage Component, because higher winter gas prices are the norm. This means in a typical year, there is little (if any) risk there will be no reward for Avista Energy.

66 For all of these reasons, the incentive in the Storage Component is inappropriate and should not be approved.

4. Transportation Component

67 The Transportation Component comprises capacity releases and off-system sales. In this Component, the Mechanism can reward Avista Energy for not just "average" achievement, but also below average achievement.

[11] Avista defended the use of benchmarks that give rewards or penalties in conditions Avista Energy cannot control. According to Avista, "in some cases, it's hard to distinguish between the differences that are caused by decisions made [by Avista Energy] and differences caused by the market." (Norwood, TR. 185:24 to 186:2). Even if one agrees with Avista, the Storage Component is one example where Avista Energy benefits in any year where the normal price pattern exists (higher prices in the winter then summer), so long as it simply follows the synthetic schedule. That is an "unearned reward" by any standard.

68 As proposed, the Mechanism would guarantee $3 million in capacity release and off-system sales revenues, with 80%/20% sharing between ratepayers and Avista Energy beyond that level. (Norwood, TR. 135:5-11.) Accordingly, the issue is whether the $3 million threshold level is fair or not. The record shows it is not fair.

69 Consider just capacity release revenues. These revenues have exceeded Avista's proposed $3 million sharing threshold each year since 1996, and they are $3.9 million in 2003, just through September. (Bench Request #2, "Cap Releases" column.) During the life of the Mechanism (Sept. 1999 to Sept. 2003), capacity release revenues have averaged nearly $3.8 million every twelve months. (Exh. 212: $5,180,621 ("Annual Average" column, line 2) times 72.72% (WA allocation) = $3,767,348.) Obviously, Avista's proposed $3 million threshold is way too low. The result is that Avista Energy is rewarded for below average performance.

70 Consider also that the "bulk" of the capacity release transactions that generated these substantial revenues are from long-term deals entered into by Avista Utilities before the Mechanism went into effect. (Parvinen, TR. 539:6-11 and Exh. 257-C at 2, 1st ¶ of the Response, last line.) Avista Energy did not make those deals, yet it benefits from them. That is not appropriate, either.

71 So based on capacity release revenues alone, the $3 million sharing threshold for Transportation is unfair. Add to this a consideration of off-system sales, and the proposed threshold is conclusively unrealistic.

72 For example, even in 2002, when Avista Energy chose to maximize basin optimization benefits at the expense of off-system sales (*see* Part IV.C, ¶¶ 80-100, below), $1.6 million in off-system sales was still achieved. (Bench Request #2.) If the 2002 basin optimization total of $4 million is added to total capacity release and off-system sales revenues for 2002, the total is over $8.94 million. ($4.9 million per Bench Request #2 + $4.04 million per Bench Request #1, total of first two lines in the "2002" column = $8.94 million.)

73 In sum, the incentive structure in the Transportation Component is improper because it unfairly rewards Avista Energy for producing well below average capacity release and off-system sales revenues, and it unfairly rewards Avista Energy for the prior efforts of Avista Utilities.

74 Avista Energy should be rewarded for its own efforts, and only when it does a good job. It should not be rewarded for below average performance, or for the prior efforts of Avista Utilities. The incentive in the Transportation Component is flawed. It should not be approved.

5. Basin Optimization Component

75 The Basin Optimization Component rewards Avista Energy whenever the basin weightings, set months earlier, do not produce the expected lowest price of gas, and Avista Energy is able to exploit the lowest price basin. (*See* discussion in ¶¶ 23-25 above.) This means Avista Energy can benefit if Avista fails to accurately predict price

differentials at the basins when setting the basin weightings, even though Avista Energy's expertise did not cause the change in price at the basins. In other words, Avista Energy does nothing to create the conditions from which it benefits. (Parvinen, Exh. 201-T at 54:2-5.) That is not a well-structured incentive.[12]

76 Moreover, Avista Energy only enters into basin optimization transactions when there is a benefit. (Parvinen, TR. 513:6-11.) This is another example of asymmetric risk in the proposed Mechanism. Indeed, there is no risk at all for Avista Energy regarding these transactions; only shared benefits. Permitting Avista Energy to reap 20% of the benefits in this context is inappropriate. The incentive structure for basin optimizations should not be approved.

6. Conclusions on the Structure of the Proposed Mechanism

77 The proposed Benchmark Mechanism is poorly structured. There are no true benchmarks for most of the gas Avista Energy purchases (Tier 1 and Tier 2). Where benchmarks do exist, they give unearned rewards and penalties.

78 Indeed, the proposed Mechanism can give Avista Energy a reward for below average performance (*e.g.*, in the Transportation Component), and a penalty for above average performance. (*E.g.*, in Tier 3.) The Mechanism will grant a reward or levy a penalty based simply on changes in market prices, not better than average performance.

[12] One way to address this problem is to adjust the basin weightings twice a year instead of once. However, this would reduce unearned basin optimization benefits. (*See* Gruber, TR. 293:19-22). Avista opposes the idea.

(*E.g.*, Storage Component.) And the risk/reward structure is asymmetric. (*E.g.*, Storage Component and Basin Optimization Component.)

79 The ratepayers do not deserve a gas incentive mechanism so fundamentally flawed. The proposed Mechanism should not be approved.

C. Avista Energy Chose to Use the Benchmark Mechanism for Its Sole Benefit, When it Could Have Chosen to Benefit Ratepayers, Too. Avista Utilities Did Nothing to Prevent It

1. Background

80 The record describes at least one example where Avista Energy was able to exploit the Mechanism for its sole benefit, and to the detriment of customers. The example involves basin optimization benefits. Though the proposed Benchmark Mechanism, if approved, would share these benefits in the future, that is not the case currently, or in the past.

81 The point is that no commission can anticipate, let alone discover, the ways in which an affiliate will use a mechanism for its own purposes. What is clear on this record is that Avista Energy has not been shown to be capable of operating an incentive mechanism to produce the lowest price for customers. Rather, Avista Energy will use that mechanism for its own self-interest.

2. How Basin Optimization Benefits Arise

82 Basin optimization benefits arise because the Mechanism prices the gas Avista Energy purchases at the three basins based on specific percentage "weightings." The

weightings are set in February each year, for use starting the following November. In actual experience, if the price at one basin becomes cheaper than predicted, Avista Energy can buy as much gas at the cheaper basin as it can, and pocket 100% of the difference between that price, and the price generated by the Mechanism at the prescribed basin weightings. (*See* D'Arienzo, TR. 375:19 to 376:10, TR. 4 42:11-24, and ¶¶ 23-25 above.)

3. How Avista Energy Exploited Basin Optimization Benefits

83 Under the Mechanism currently in effect, all basin optimization benefits flow exclusively to Avista Energy. (*E.g.*, D'Arienzo, TR. 375:4 to 376:10.) Avista frankly admitted that under the current Mechanism, Avista Energy has both the choice and the incentive to exploit these basin optimization benefits for itself. (*See* Norwood, TR. 260:16-25.)[13]

84 By 2002, this choice and incentive became very apparent to Avista Energy. The results are now apparent to all: Avista Energy realized over $4 million in basin optimization benefits in 2002, and $1.2 million in the first two months of 2003 alone. 100% of these benefits went to Avista Energy; the ratepayers got none of them. (Parvinen, TR. 541:6-9 and 540:5-8, Bench Request #1, 2002 and 2003 columns,

[13] Mr. D'Arienzo also referred to this strategy at TR. 384:16-19, where he testified that if capacity is available to move the lowest cost gas to the utility "I capture that value in the basin optimizations …" As Avista admitted, under the current Mechanism, 100% of that value goes to Avista Energy. (D'Arienzo, TR. 442:11-24).

respectively, sum of figures on the first two lines. *See also,* Gruber, TR. 366:13-22 and TR. 364:20-23.)

85 By contrast, Avista Energy did only $1.6 million in off-system sales in 2002. (Bench Request #2.) The reason for this low figure is because under the current Mechanism: "… Avista Energy has the choice of entering into an off-system sale or doing the basin optimizations." (Parvinen, TR. 540:12-14.)

86 In other words, during 2002, Avista Energy was foregoing off-system sales opportunities that would have been shared with customers after sharing thresholds were reached. (Parvinen, TR. 540:19 to 541:5.) For basin optimization benefits, there was no sharing threshold. Indeed, there was no sharing at all.

87 Avista Energy was able to exploit basin differentials in 2002 because gas was cheaper at the Rockies basin. As a result, the Rockies basin served 33 percent of all volumes used to serve the Utility during 2002, at a time when the Mechanism prescribed a Rockies basin weighting of only 18%. (D'Arienzo, TR. 375:4-8, Exh. 118.)

88 If Avista Energy had the interests of ratepayers in mind, substantially more than $1.6 million in off-system sales would have been achieved, and shared with ratepayers. (Parvinen, TR. 541:10-14.)

89 Perhaps as troubling as the millions of dollars that went to Avista Energy alone as a result of its use of the Mechanism, is the fact that Avista Utilities apparently did nothing to challenge it. Avista Utilities claims it has "administrative oversight" of

Avista Energy's use of the Mechanism. (Gruber, Exh. 51-T at 1:11-12.) For whatever reason, that oversight was ineffective to protect ratepayers.

90 In sum, when Avista Energy had a choice, it chose to use the Benchmark Mechanism to promote its self-interest, rather than the interests of the ratepayers. As a result, Avista Energy reaped millions of dollars in basin optimization benefits, and the Utility's customers got none. Avista Utilities either condoned, or did nothing to stop that activity.

4. The Facts Do Not Support Avista's Attempts to Excuse Avista Energy's Sole Use of Basin Optimization Benefits

91 Avista wants the Commission to believe the interests of Avista Utilities and Avista Energy are "aligned," and that Avista Energy tried to get the "lowest cost" of gas for Avista Utilities. (*E.g.,* Norwood, Exh. 3-T at 14:3-6 and D'Arienzo, TR. 414:18-21.) However, the facts discussed above prove Avista Energy optimized basin differentials for its sole benefit, instead of doing transactions that would give ratepayers a benefit, too. This reflects a severe misalignment of interests. The result is that Avista Energy did not produce the lowest cost of gas for the ratepayers.

92 Avista's witnesses tried to explain away this issue by contending that basin optimization benefits were intended to compensate Avista Energy for "load volatility" in Tier 3 (known as Tier 2 under the existing Mechanism). (Norwood, TR. 149:17-20, D'Arienzo, TR. 376:7-10.)

93 Avista's contention is not credible, for two reasons. First, Avista's "risk compensation" concept was in fact an unintended consequence of the Mechanism. As to the risk, Avista made clear it "had no idea [such volatility] was there … " (D'Arienzo, TR. 408:2-7.) As to the compensation, Avista was equally clear: It was not until Avista Energy began to look for ways to make more money that it discovered the use of basin optimization benefits. (D'Arienzo, TR. 377:7-12.)

94 Second, Avista's "risk compensation" concept was never explicitly addressed in any document Avista filed with the Commission. (Norwood, TR. 149:25 to 150:8, D'Arienzo, TR. 376:23 to 377:6.) Accordingly, that concept was neither explained to the Commission, nor approved by it.

95 Avista also tried to deflect attention from the basin optimization issue by complaining that Avista Energy was a net loser under the Mechanism. (*E.g.,* D'Arienzo, TR. 439:19-25.) In fact, Avista Energy made money off the Mechanism every year except one: 2000. (Bench Request #1, last line.) That year was during the California Energy Crisis, and Avista Energy lost a whopping $8.8 million. (Norwood, TR. 196:24 to 197:15.)

96 Inexplicably, it was not until April 2002 that the Mechanism was changed "to avoid" this risk to Avista Energy. (Gruber, TR. 269:24 to 270:25.) Yet when Avista was changing the Mechanism to reduce Avista Energy's risk, it made no change to Avista Energy's ability to unilaterally exploit basin optimization benefits. This allowed Avista

Energy to reap millions in basin optimization benefits after April 2002, while enjoying a substantially reduced risk exposure at the same time. It is disquieting to realize Avista would not have even raised the basin optimization benefits issue in this docket had Staff not discovered the issue. (*See* Norwood, TR. 150:9-19 and 151:5-16).

5. Conclusions on Avista Energy's Use of the Mechanism to Reap Unilateral Basin Optimization Benefits

97 Reading the foregoing evidence in a light most favorable to Avista, at least three conclusions can be reached: 1) Under the Mechanism, Avista Energy had significant and unanticipated risk that arose under unanticipated and unprecedented market conditions; 2) The Mechanism did not address that problem in a timely fashion; and 3) Avista Utilities failed to protect ratepayers by requiring Avista Energy to engage in different transactions to share benefits with customers.

98 The moral to this story is that Avista Energy can and will act in its economic self-interest, to the detriment of ratepayers, whenever it can find a loophole in the Mechanism. When that happens, the Commission cannot count on Avista Utilities to protect ratepayers.

99 Neither the Commission, nor any other regulator, can anticipate all possible ways a mechanism of this type can be used to benefit a utility's affiliate at the expense of the ratepayers. What is clear is that the Benchmark Mechanism has in fact been used to benefit Avista Energy alone, at the expense of millions of dollars to the ratepayers.

100 Enough. This experiment should be cancelled now.

D. The Benchmark Mechanism is Inconsistent With the Commission's Policy Statement on Gas Incentive Mechanisms

1. Background

101 In 1997, the Commission issued a Policy Statement in Docket No. UG-940778 on Purchased Gas Incentive Mechanisms. (Exh. 210.) The Policy Statement is not a Commission "rule," and by its own terms, it is not "binding." (*Id.,* at 1, 2nd ¶.) This is consistent with the "advisory" nature of such statements. (RCW 34.05.230(1).) Still, the Commission intended "to use [the Policy Statement] in … developing its opinions and judgments concerning specific regulatory issues which it may be required to address." (Exh. 210 at 1, 2nd ¶.)

102 Moreover, because both Staff and Avista agree the principles contained in the Policy Statement retain current validity (Parvinen, Exh. 201-T at 38:14-18; Norwood, TR. 185:10-13), it is appropriate for the Commission to use the Policy Statement to evaluate the proposed incentive mechanism in this docket.

103 Staff explained in detail why the proposed Mechanism fails to satisfy most of the Principles in the Policy Statement. (Parvinen, Exh. 201-T at 38-47.) Public Counsel agreed with Staff's conclusion. (Elder, Exh. 251-T at 3:1 to 4:6.)

104 By contrast, in its direct case, Avista specifically addressed only Policy Statement Principle, #10, which simply states the Commission would avoid a "one-size-fits-all" approach in evaluating a gas incentive mechanism. (Exh. 210 at 3, ¶10; Norwood, Exh.

1-T at 11:14 to 12:3.) Avista waited until rebuttal to provide its analysis of the other Principles in the Policy Statement. (Norwood, Exh. 3-T at 14:7 to 15:5 and Exh. 6.)

2. The Proposed Benchmark Mechanism Fails to Satisfy Most of the Principles Enunciated in the Policy Statement

105 Staff will not restate here its analysis of the Commission's Policy Statement. We refer the Commission to Mr. Parvinen's testimony in Exhibit 201-T at 38-47 for that purpose. We summarize here a few of the principal reasons why Avista's rebuttal analysis of the Policy Statement falls short.

106 First, Avista's rebuttal case is fundamentally flawed because it fails to explain how or why the Policy Statement should apply to a Mechanism involving an affiliate. The Policy Statement contains no principle or policy addressing the use of affiliates in purchased gas incentive mechanisms. Surely the Commission would have addressed that issue if it had been brought to the Commission's attention. Consequently, it is speculative whether the Policy Statement even applies to the proposed Mechanism, since it uses an affiliate.

107 Second, Avista's case fails to show compliance with key Principles #1 and #4, which require incentive mechanisms to compare the utility's performance "to an external benchmark of cost." Avista says, "the commodity portion [of the proposed Mechanism]… includes an external benchmark of market prices, against which to measure performance." (Exh. 6 at 1, Items 1 and 4, and at 2, Item 11.) But these statements are either false or misleading, because the bulk of the Commodity

Component, Tier 1 and Tier 2 (100% of Avista's average daily load), have no benchmark whatsoever against which to measure performance. (*See* ¶¶ 55-56 above.) This is plainly contrary to Policy Statement Principles #1 and #4.

108 Third, the proposed Benchmark Mechanism violates Principle #5, which requires risks and rewards to be symmetrical. (Exh. 210 at 2.) As we explained above, in the Storage Component, the reward is automatic under typical market conditions. In the Basin Optimization Component, there is no risk, only reward. (*See* ¶¶ 65 and 76 above).

109 Finally, the Policy Statement requires the use of benchmarks that provide the utility the "incentive to perform better than the market." (Exh. 210 at 2, Principle #4.) The proposed Benchmark Mechanism violates this basic principle as well. As we explained above, in Tier 3, Avista Energy can be rewarded (or penalized) for performance equal to the average performance in the daily market, so long as that average performance happens to yield prices lower (or higher in the case of a sale) than the FOM index. (See ¶¶ 57-60 above.) And the Transportation Component (off-system sales/capacity releases) rewards Avista Energy for below average performance, and permits it to benefit from deals made by Avista Utilities before the Mechanism went into effect. (*See* ¶¶ 61-64 above.)

110 In each of these instances, Avista Energy is rewarded even when it fails to beat the market, or does little or nothing to earn the reward. In addition to all the other problems surrounding the proposed Benchmark Mechanism, these basic features of the

Mechanism are simply not the indicia of a well-conceived incentive mechanism the Commission's Policy Statement contemplates, and the ratepayers deserve. The Commission should not approve the proposed Benchmark Mechanism.

E. Avista Failed to Prove Ratepayers are Getting a Good Deal With the Benchmark Mechanism

1. Background

111 Avista attempted to prove ratepayers are getting a good deal with the Mechanism. Avista's table (Exhibit 53-T at 3) was the focal point of the discussion at hearing on this issue. That table compares Avista's analysis with a similar analysis in Exhibit 208, sponsored by Mr. Parvinen for Staff.

112 As we demonstrate below, the Commission needs to know Avista Energy's cost in order to properly evaluate whether ratepayers are getting a good deal or not. Avista has not provided that cost. Furthermore, the analysis in Avista's table is incomplete because it fails to account for several relevant costs and benefits. In any event, based on the limited data available, Staff proved ratepayers are worse off by around $1.6 million with the Mechanism.

2. Avista Cannot Prove Ratepayers are Getting a Good Deal Because Avista Has Not Proved Avista Energy's Cost to Serve the Utility

113 As Staff explained: "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." (Parvinen, TR. 497:23-25.) Avista has not provided proof of Avista Energy's cost to

serve the Utility. (*See* ¶¶ 42-52 above.) Accordingly, Avista cannot prove ratepayers are getting a good deal with the Benchmark Mechanism.

3. The Table on Page 3 of Exhibit 53-T is Unreliable Because It Does Not Reflect the Value of All Relevant Costs and Benefits

114 Even if we ignored the fact that Avista has not provided Avista Energy's costs, Avista still has not made a case that ratepayers are in fact getting a good deal. A major reason is that several material items are not measured on Avista's table on page 3 of Exhibit 53-T. The following examples apply equally to the Company and Staff analyses summarized on that table.

115 First, Avista's table does not measure the fair market value of Avista Utilities' storage capability, which Avista Energy has been given the right to manage and use under the Agency Agreement. Staff asked for that value, but Avista did not have it, and did not obtain it. (Exh. 62-C at 1, Gruber, TR. 279:6-24, and Parvinen, TR. 536:20 to 537:8.)

116 Second, Avista's table does not measure the value to Avista Energy of using the Utility's gas portfolio in Avista Energy's total gas portfolio. (Parvinen, TR. 537:9-14.) As Staff described the issue:

> If Avista Energy can take those contracts and manipulate those in such a way that it makes a profit, shouldn't Avista Utilities' customers benefit from those?

(Parvinen, TR. 520:15-18.) Avista's table fails to consider, let alone answer that question.

117 Third, Avista's table fails to account for the fair market value of the Utility's transportation assets used by Avista Energy. Avista Energy testified its business is "set up to trade around physical assets." (D'Arienzo, TR. 405:21-406:5.) The Utility provides 58% of the total transportation capacity managed by Avista Energy. (Exh. 117 at 2, last line.) The right to use that capacity is a very valuable right, yet the fair market value of that right has not been determined.

118 The Company responds that only 20% of Avista Energy's total transportation capacity is available for Avista Energy's use because the remaining transportation capacity, as well as Jackson Prairie storage and the Plymouth LNG facility, are needed to meet the Utility's customers' needs. (D'Arienzo, TR. 443:1-4.) This is not convincing, in part because the record suggests Avista Energy has in fact used Jackson Prairie or the Plymouth LNG facility for non-utility purposes. (*See* D'Arienzo, TR. 443:22 to 444:3.)

119 Moreover, in the end, Avista agreed it must be in balance on its total portfolio each day. (D'Arienzo, TR. 406:14, as explained in Exh. 206, and Parvinen, Exh. 201-T at 21:17 to 22:11.) Avista Energy is able to use Avista Utilities' assets to do that. In any event, even at 20%, the Utility provides a substantial amount of capacity that Avista Energy gets to manage.

120 Avista's table also fails to reflect how the Utility would have performed had it conducted its own gas procurement over the 1999 to 2003 period. This is a critical issue, because Avista agreed the Utility would manage its portfolio differently now than in

1999, when the Mechanism went into effect. (Gruber, TR. 273:23 to 274:3.) Yet the analyses on Avista's table make no attempt to give Avista Utilities credit for that different management approach.

121 Finally, Avista's table fails to reflect costs associated with the natural gas market such as counterparty risk, nomination errors, and the like. (D'Arienzo, Exh. 102-T at 10:9-11.)

122 In sum, Avista's table is incomplete and therefore unreliable because it fails to adequately capture all values relevant to a defensible cost/benefit analysis.

4. Even Ignoring the Foregoing Deficiencies in Avista's Analysis, the Record Shows Ratepayers Are Not Getting a Good Deal With the Benchmark Mechanism

123 Avista's table reflects the efforts of both Staff and Company to measure whether ratepayers are getting a good deal from the Benchmark Mechanism. Apart from the deficiencies in the analyses described above, there remain other significant and complex issues of controversy on this issue.

124 Avista's table in Exhibit 53-T, page 3 shows the three distinct areas of difference between the Staff and Company analyses: 1) Currency Risk; 2) "Load Volatility"; and 3) Transportation benefits. As we explain below, the most defensible analysis shows ratepayers are not getting a good deal under the Mechanism, even if the Commission were to ignore all other deficiencies in the Mechanism.

a. Currency Risk

125 Staff contends there is an equal chance the Canadian dollar will weaken or strengthen relative to the American dollar. Therefore, currency risk will even out over time, and the net cost for currency risk should be zero. (Parvinen, Exh. 201-T at 32:13-17.)

126 By contrast, Avista assumes the Canadian dollar will steadily strengthen against the American dollar, resulting each year in a cost of $176,000 to the Utility (Exh. 53-T at 3:16.) Avista's only defense for this assumption is its analysis of a specific time period (August 1, 2002, to August 1, 2003), in which there was indeed a net strengthening of the Canadian dollar. (Gruber, Exh. 53-T at 12:18-21.)

127 To be valid, however, Avista's analysis must demonstrate its selected time period is representative. Because Avista made no such showing, its currency assumption is arbitrary. Avista's case also contradicts Avista's point that "there can be a significant exposure to currency shifts during each year in both directions." (Gruber, TR. 282:11-18 and Exh. 63, last sentence.) Avista's currency analysis looks only in one direction.

128 An analysis of the currency fluctuation during the same time period Avista used to evaluate the Mechanism overall further confirms Avista's approach is arbitrary. That time period was September 1999 through February 2003. (Exh. 55-C.) The currency fluctuation over that period showed the opposite of Avista's analysis: The Canadian

dollar weakened against the American dollar. (Exh. 63, as explained by Mr. Gruber at TR. 281:22 to 282:8.)

129 In short, Avista's currency analysis is invalid because it is based on a time period that was not proven to be representative. Staff's estimate, reflecting an equal chance of currency swings up or down, is the only defensible estimate on this record.

b. "Load Volatility"

130 In the analysis of what Avista calls "load volatility," the parties attempted to measure Avista Energy's share of the benefits and costs for which the Utility would be responsible, if the gas procurement function returned to the Utility. (Parvinen, Exh. 201-T at 32:18 to 34:18.)

131 There are three areas of contention that result in the difference between Staff's figure (which shows a net benefit of $1,759,855),[14] and Avista's figure (which shows a net cost of $231,000.) The Staff/Company dollar difference on this issue is $1,991,000. (Gruber, Exh. 53-T at 3:17.) We address each issue area below.

(1) The Return of the Gas Procurement Function to the Utility Means Benefits That Would Have Accrued to Avista Energy Would Accrue to Avista Utilities

132 Most of the $1,991,000 Staff/Company difference for "load volatility" is related to Staff's position that the 20% of benefits that go to Avista Energy under the proposed Mechanism would go to Avista Utilities, if the gas procurement function returns to the

[14] The detailed supporting calculations for Staff's figure are shown in Exhibit 209-C, lines 1-10.

Utility. These benefits come from the winter/summer differential benefits of storage, the peaking benefits of storage, and capacity release/off-system sales revenues. (Parvinen, Exh. 201-T at 35:2-8 and Exh. 209-C:1-10.) It is appropriate to assume the Utility would receive 100% of these benefits, rather than sharing them, if the gas procurement function were to return to the Utility. Staff's figure reflects this consideration, Avista's does not.

133 The dollar impact of this issue is equal to 20% times the amounts shown on lines 4, 5, and 8 of Exhibit 209-C, for a total of $1,538,422.20. Though Staff described this issue in its direct case (Parvinen, Exh. 201-T at 34:14 to 35:8), Avista did not address it on rebuttal, nor was it raised at hearing. Staff's analysis is sensible and should be accepted.

(2) Avista Utility's Ability to Use Storage on a Daily Basis to Manage Loads Provides Benefits That More than Offset "Load Volatility"

134 The second issue on "load volatility" involves the management of Tier 3 gas supplies. Recall Tier 3 involves the daily balancing of the Utility's actual loads, above or below its average estimated load.

135 Staff contends the cost of the volatility around Tier 3 gas largely can be avoided by using storage on a daily basis. (Parvinen, Exh. 201-T at 33:3-14, TR. 482:1 to 483:9.) There is no dispute about the concept: Avista agrees it can use storage daily to manage

Tier 3 risk. (Norwood, TR. 130:12-16.) Avista simply failed to measure the benefit of doing so in its analysis.

136 By contrast, Staff gave thorough consideration to the ability of Avista Utilities using storage to balance its daily load requirements. Staff concluded that any potential cost associated with the unavailability of storage during two "shoulder" months of the year could be fully offset if Avista Utilities manages its assets in a prudent manner. (Parvinen, Exh. 201-T at 33:18 to 34:10.)

137 Staff also testified these offsetting, or "positive" situations can occur in the other 10 months of the year as well. These situations include: 1) When loads are less than supplies, and the daily price is greater than the FOM index. In this situation, the gas can be sold in the daily market rather than be injected into storage; and 2) When loads are greater than supply, and the daily index is less than the FOM index. In this situation, gas would be purchased at the daily rate rather than be withdrawn from storage. (Parvinen, Exh. 201-T at 34:1-8.)

138 Avista criticized Staff for not quantifying the effects of the potential costs during the two "shoulder" months each year, and the "positive," offsetting scenarios under which the Utility would use the daily market instead of storage to manage its daily needs. (D'Arienzo, Exh. 102-T at 8:23 to 9:19, Gruber, Exh. 53-T, at 8:27-9:26.)

139 However, Staff did address the level of potential costs around the two "shoulder" months in question. Staff testified that when it analyzed one of the two

months of the year when storage might not be available for daily use, the cost to the Utility turned out to be nominal, only about $8,500. (Parvinen, TR. 481:1-18.)

140 Moreover, Avista's own "scenario" evidence in fact proves Staff's point regarding the level of offsetting or "positive" situations. In its analysis, Avista computed the frequency in which four scenarios have occurred over the life of the Mechanism, when storage might be used to manage the Utility's loads. Each of the four scenarios Avista studied relate to daily loads and daily prices. Avista computed a total net cost to the Utility under the Mechanism of $7,915,934 ($2,261,695 annualized) for the four scenarios. The results are summarized in the table on page 9 of Exhibit 102-T. (*See also,* Gruber, Exh. 55-C.)

141 The problem for Avista is that Scenarios 2 and 3 on page 9 of Exhibit 102-T are exactly the same "positive" situations Staff identified. Accordingly, Scenarios 2 and 3 in fact provide a total benefit of $2,233,671, to offset the costs during the two "shoulder" months of each year when storage is unavailable. (Parvinen, TR. 483:5-9 and D'Arienzo, Exh. 102-T at 9, last line of table.)

142 Staff also pointed out that the costs associated with Avista's Scenarios 1 and 4 (over $10 million total) could be avoided by the Utility's prudent use of storage. By contrast, Avista's Scenarios 1 and 4 assume Avista Energy's only option is to purchase or sell gas under adverse market conditions. (Parvinen, TR. 513:9 to 515:9 and Exh. 102-T at 9, 2nd to last line of the table.)

143 Staff explained that the Scenario 1 and 4 costs could be avoided by either: 1) Injecting the excess gas into storage, rather than selling into daily market at a loss for Scenario 1; or 2) Withdrawing gas from storage on days where more gas is needed, rather than buying gas at daily prices that are higher than FOM for Scenario 4. (Parvinen, TR. 482:23 to 483:4.)

144 Accordingly, instead of a substantial net cost, as Avista claims (Exh. 102-T at 9, table and Ex 55-C), there would actually be a net benefit to customers, assuming Avista used its storage assets in a prudent manner when it resumed the gas procurement function.

145 Indeed, Staff was being conservative in favor of the Company by reflecting "zero" as the net cost of the daily volatility, instead of a net benefit that is supported by the record. (Parvinen, TR. 478:8 to 484:8 and Exh. 209-C, line 3.)

(3) Staff Did Not "Double Count" Storage Benefits

146 The Company then criticized Staff for allegedly "double-counting" storage benefits. (Gruber, Exh. 53-T at 8:21-24.) However, this criticism is also unfounded.

147 There is no double counting because Staff's storage analysis addressed two distinct situations. One involves Avista's Scenarios 1-4, *i.e.*, using storage to manage "load volatility" on a daily basis, using the current daily index as a decision guide. The second situation involves what Avista calls "Storage Peaking Benefits." (*See* Gruber, Exh. 55-C, "Peaking Benefits" line, and Parvinen Exh. 209-C, line 5.) This situation

involves the capability of storage to be used for peaking supplies, only if the gas could be replaced later at a future price lower than the current day's index. In other words, "Peaking Benefits" address benefits of storage above and beyond the daily index.

148 Thus, there is no "double counting" because each of these situations reflects a distinctly different benefit of storage. Each needs to be counted.

c. Transportation Benefits

149 The last Staff/Company difference shown on Avista's table on page 3 of Exhibit 53-T, involves the estimated impact on transportation benefits if the gas procurement function returned to the Utility. Avista estimates a $2 million loss in capacity release and off-system sales revenues. Staff estimates a loss of $0, for a Staff/Company difference of $2,000,000. (Exh. 53-T at 3:19.)

(1) Avista's Calculation is Improper Because it Considered Abnormal Results

150 Avista's calculation compared Avista Energy's actual achieved capacity release/off-system sales revenues from the inception of the Mechanism, to Avista's estimate of what the Utility would have achieved during the same time period. (Gruber, Exh. 51 at 5:18-6:4.)

151 However, in calculating Avista Energy's actual results, Avista included two months during the Energy Crisis (November and December 2000), when prices spiked, and Avista Energy reaped a $10.4 million windfall in off-system sales. This is an average of $5.2 million per month, which is unrepresentative. By comparison, the next

highest month during the entire 3½ years of the Mechanism was only $900,000. (Parvinen, Exh. 201-T at 36:16 to 37:4, and TR. 483:20-22.)

152 Accordingly, when trying to determine what reasonably can be achieved in the Transportation area in the future, the months of November and December 2000 need to be normalized. Staff's calculation did so; Avista's did not. (Parvinen, Exh. 209-C:22-31.)

153 Avista did not take exception to Staff's normalization adjustment. However, Avista criticized Staff for not normalizing what Avista called "the other side of the equation," which is the estimated level of achievable benefits by the Utility, if the Utility were performing the gas procurement function itself. (Gruber, Exh. 53-T at 6:27 to 7:1.)

154 However, Staff explained that, unlike the very evident anomaly period related to the Avista Energy side of the equation, the monthly data supporting the estimate of how the Utility would have performed did not demonstrate the same anomaly. (Parvinen, TR. 486:23-487:2.) Nonetheless, to answer any concerns about the fairness of the calculation, Staff noted that it was in fact conservative in its analysis by using a zero figure (shown on the Staff side of the Company's table in Exh. 53-T at 3:19), instead of the actual net benefit amount Staff calculated in Exhibit 209-C, line 21. (Parvinen, TR. 487:3-5 and Exh. 201-T, 37:6-12.)

155 Moreover, even if the "Utility's side" of the equation were normalized, the result is only a small net cost to the Utility; some $230,000. As Staff testified:

> Q: Well, to be – to be fair about it, wouldn't it be more appropriate, if you're going to normalize one side of the equation, so to speak, to

normalize the other? And if you're going to pull out 10 million on one side as anomalous, why wouldn't you pull it out on the other side, if the utility had been operating the mechanism.

A: I looked at those months, and it did not appear that the anomaly existed. I have, since then, gone through and said, Okay, well fine. If we normalize that period, what does this number come out to. And the negative number on line 21 does become slightly positive. It was – would become 230,000, which I would put on line six on that number, so if you were to normalize both sides, I came up with a number that was 230,000 instead of at zero.

(Parvinen, TR. 487:17 to 488:7.)

156 This calculation shows Staff's conclusion is reasonable, especially given Staff's conservative approach to the adjustment.

157 Staff's calculation was conservative in another way not specifically measured in the calculation, because Staff did not reduce the estimated level of revenues from contracts the Utility would not have entered into, as shown on line 13 of Exhibit 209-C. This is conservative in favor of the Company because as Avista agreed, the Utility would not be operating the same as it had before the Mechanism went into effect. (Gruber Exh. 51-T at 4:3-16 and TR. 273:23 to 274:3, *see also* Parvinen, Exh. 201-T at 36:5-15.) If the Utility were prudently operating in the current environment, a higher level of off-system sales than Avista estimated would be achievable, compared to before. (Parvinen, TR. 535:22 to 536:7.) Both Staff's and Avista's calculations fail to capture those benefits. (*Id.*, and Parvinen Exh. 201-T at 36:12-15.)

2) Avista's Late Exhibit Does Not Rescue Its Failed Argument

158 Avista offered a late exhibit (Exh. 214) in an attempt to rebut Staff's testimony regarding the normalized level of capacity release/off-system sales revenues that would have been achievable by the Utility. However, there are several problems with Avista's analysis in Exhibit 214 (in addition to the fact it was not able to be examined through a Company witness.)

159 First, Avista admits that performing the normalization calculation on the revenue that would have been achievable by the Utility is "problematic." (Exh. 214, 2nd ¶ of response, 1st sentence.) This is independent confirmation that Avista's normalization calculation of "the other side of the equation" is difficult to defend. This also confirms that the conservative approach taken by Staff remains reasonable and appropriate. (Parvinen, Exh. 201-T at 37:6-12.)

160 Second, as Avista's exhibit states, Avista assumed certain "benefits would not have been captured by the utility because, as described in Workpaper 4, standard practice for the utility was 'When the utility did off-system trading, almost all trading activity was done on a monthly basis.'" (Exh. 214, 2nd ¶ of response.) Avista's assumption is flawed for the same reason we just explained: the Utility would not use the same management practices it used before the Mechanism. (See ¶ 157 above.)

161 Thus, Staff was being extremely conservative when it removed all revenues in Exhibit 209-C, line 13, using the same assumption Avista used. (Parvinen, TR. 535:11 to 536:7.)

162 In sum, the bottom line result of Staff's analysis showing no net loss of benefits associated with capacity release/off-system sales is more than fair.

d. Conclusions

163 Whether the Mechanism is a "good deal" for ratepayers cannot be decided until Avista produces Avista Energy's actual cost to serve Avista Utility's load. Avista has not provided that cost, nor has it reflected the value of the numerous other relevant costs and benefits.

164 Even if one were to excuse these infirmities in Avista's case, the only conclusion consistent with the record is Staff's conclusion that there is a net benefit to ratepayers by a return of the gas procurement function to the Utility.

V. OVERALL CONCLUSIONS AND RECOMMENDATIONS

165 The Commission should allow Avista's proposed Benchmark Mechanism to expire, subject to a 60-90 day extension from the termination date of the current tariff (January 29, 2004), to permit Avista to "unwind" the current Mechanism.

166 Avista's proposed Mechanism should not be approved because it is not a true or reasonable benchmark mechanism. Most of the load covered by the Mechanism has no true benchmark associated with it. Where true benchmarks do exist, they are illogical

and asymmetric. They can reward Avista Energy for average, or even below average performance, and even when Avista Energy does no better than the daily market.

167 Ultimately, the Mechanism represents a set of affiliated interest transactions without any proof that what the ratepayers receive is being provided at the lower of Avista Energy's cost, or market. That is inconsistent with the requirements of Chapter 80.16 RCW, and the Commission's application of that statute.

168 This experiment has lasted over four years. The problems have not changed. The problems have not been solved. It is time to end the experiment.

DATED this 22nd day of December, 2003.

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