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

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| In re the Matter of<br><br>WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br><br>Complainant,<br><br>vs.<br><br>AVISTA CORPORATION d/b/a AVISTA UTILITIES,<br><br>Respondent. | ) | DOCKET NO. UG-021584<br><br>POST-HEARING BRIEF OF AVISTA CORPORATION |

1 Avista Corporation (hereinafter "Avista," the "Utility," or "Company"), respectfully submits this Post-Hearing Brief in the above-captioned matter.

## I. INTRODUCTION: AN OVERVIEW OF THE MECHANISM AND SUMMARY OF KEY POINTS

### A. An Overview Of The Mechanism And Its History

2 Avista's "Benchmark Mechanism" was originally implemented in Washington in September of 1999 (Docket No. UG-990614), for a period extending to March 31, 2002. Subsequently, on November 7, 2001, the Company filed a Petition to extend the Mechanism until March 31, 2005. The Commission, however, approved a one year extension of the Mechanism (in Docket No. UG-011500), through March 31, 2003, which included modifications to the Mechanism that incorporated, e.g., a gas procurement hedging strategy ("tiered commodity") meant to reduce the level of gas cost volatility and risk, while still providing customers with a reliable supply of natural gas. (Norwood Direct, Exh. 1T, p. 6, ll. 1-9).

3 Subsequently, on November 29, 2002, Avista filed a request to extend the duration of the Mechanism until March 31, 2007, along with some additional changes that provided additional flexibility in the management of the Mechanism by Avista Energy.[1] The November 29, 2002 petition was suspended, and the existing Tariff Schedule 163 was extended for an additional year until January 29, 2004, and the matter was set for hearing. (Id. at p. 6, ll. 14-18).

4 Meanwhile, in response to concerns raised by Commission Staff when the matter was set for hearing, Avista submitted, as a "preferred alternative," further tariff revisions on April 21, 2003. (Exh. 153 is the "preferred alternative" of Tariff Schedule 163; Exh. 152 is the Benchmark Tariff originally filed on November 29, 2002.)

5 A Settlement Agreement (Exh. 300) was entered into by the parties and presented to the Commission on September 23, 2003. On October 6, 2003, the Commission issued its Fourth Supplemental Order, Approving, in part, and Rejecting, in part, the Settlement Agreement. Commission Staff and Public Counsel withdrew from the Settlement Agreement and the matter was again set for hearing.

6 The Company is requesting that its "preferred alternative" of the Mechanism (Exh. 153; Tariff Schedule 163) be approved by the Commission for a period extending until March 31, 2007.[2] Appendix A is a copy of Exhibit 52, page 8 of 8, attached for ease of reference, which compares the features of the Mechanism currently in place, and the “preferred alternative.”

In its "preferred" form, the Mechanism has also been revised to address concerns expressed by Staff in the following areas: (1) the concept of "basin optimization" will provide

[1] These changes included the use of storage capability in "commodity tier three" to help reduce daily gas prices and more flexibility in the Company's hedging and storage synthetic cycle schedules; also, changes were made to enhance the auditability of the Mechanism. (Exh. 1T, p. 6, ll. 10-15).

[2] While the "preferred alternative" (Exh. 153) is proffered for Commission acceptance, the Company would still be willing to implement the version of the tariffs (Exh. 152) that were filed on November 29, 2002.

additional benefits from the price differential between supply basins that will be passed on to customers beyond what are already reflected in the existing basin percentage weightings; (2) greater use of storage will be made to cover daily load variations – i.e., customers will receive the benefits and risks associated with additional injections and withdrawals of storage to cover daily load variations; (3) there are symmetrical sharing incentives – all components of the Mechanism will share risks and rewards on the basis of 80% to customers and 20% to Avista Energy; (4) auditability is assured – i.e., additional changes to the Mechanism will assure that all components of the Mechanism are fully auditable. (Norwood Direct, Exh. 1T, p. 5, ll. 1-19).

7 It is also important to recognize that the Company administers this Mechanism in each of its primary natural gas jurisdictions (Washington, Idaho and Oregon). Both the Idaho and Oregon Commissions originally approved the Mechanism in 1999, and in 2002 extended it through March 31, 2005. The Staffs of both Commissions have been supportive to date. The Idaho Staff, for example, in their January 11, 2002, comments stated:

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

9 (Norwood Rebuttal, Exh. 3T, p. 5, ll. 1-20). Comments filed by the Oregon Commission Staff on March 12, 2002, echo similar sentiments:

10 > The GBM [Gas Benchmark Mechanism] provides an incentive to Avista Utilities to minimize natural gas costs by consolidating the natural gas procurement function under Avista's affiliate, Avista Energy. It also provides gas cost savings to Oregon customers, and because Avista Corporation and its shareholders take on more risk related to gas procurement operations than under the Purchased Gas Adjustment (PGA), there is less risk to Oregon customers . . . .

(Id.) As summed up by Company Witness Norwood, the Mechanism "continues to operate successfully in both Idaho and Oregon and has been refined over time based on the experience gained and periodic discussions with the respective Commission Staffs." (Id.) To further underscore this point, Mr. Norwood, testified:

11 > It is administratively efficient and cost effective to continue this Mechanism in all three jurisdictions, including Washington. To bring all of the gas procurement functions back inside the Utility to serve the needs of one of three jurisdictions could prove cumbersome and inefficient.

(Norwood Direct, Exh. 1T, p. 7, ll. 3-6).

12 Company Witness Hirschkorn describes the accounting and reporting procedures relative to the Mechanism. As he explains, the Mechanism works in connection with the existing Purchased Gas Cost Adjustment Tariff Schedules 150 and 156. (Hirschkorn Direct, Exh. 151, p. 2, ll. 7-15) .

13 The Company files quarterly reports with the Commission that summarize the activity and market indicators relating to the Mechanism. This information and the documentation includes retail customer usage by jurisdiction, index prices for appropriate months, Capacity Releases, Off-System Sales, calculation of associated margins, all hedging and fixed pricing locked in for the Utility, invoices between Avista Energy and the Utility, as well as the Utility's accounting transactions, as explained by Mr. Hirschkorn. (Exh. 151, p. 3, ll. 8-14).

14 It is important to recognize, as testified to by Mr. Norwood, that approval of the Benchmark Mechanism by this Commission "does not constitute pre-approval of natural gas costs." (Exh. 3T, p.11, ll. 9-12). The Company does not dispute the Commission's authority to review and adjust Avista Utilities' gas costs during a subsequent PGA proceeding. (Id.)

**B. Summary of Key Points**

15 By way of summary, Avista asks that the Commission keep the following key elements in mind when considering the record in this proceeding:

16 • The Mechanism has been in place since 1999 in Washington, Idaho and Oregon and has proven to be adaptable over time to respond to changed market conditions; given greater market volatility than was observed when the Mechanism was first implemented, there is an even greater need now for such a Mechanism. [Section III.A.]

17 • Notwithstanding issues surrounding the workings of particular components of the Mechanism, there is substantial agreement around the basic structure of the Mechanism:
(1) the use of a tiered purchasing strategy;
(2) use of Jackson Prairie storage to capture summer/winter differentials and to cover a portion of daily load variability;
(3) the use of pipeline Capacity Releases and Off-System Sales to gain additional value;
(4) the optimization of supply basin price differentials for the benefit of customers;
(5) the reduction of price fluctuations and risk for Avista Utilities through the purchasing strategies; and
(6) the need to align the interests of Avista Energy and Avista Utilities, so that Avista Energy is only rewarded when customers benefit. [Section II.D.]

18 • Avista's customers benefit from Avista Energy's participation, given the latter's greater market presence, its economy of scale, its expertise, and, in the final analysis, the allocation of risks and rewards that provide an incentive to operate in the best interests of customers. [Section III.A.]

19 • Implementation of the Mechanism is overseen by a Strategic Oversight Group, with representatives from both Avista Utilities and Avista Energy; the "decisionmaker" in the process, however, is Avista Utilities – it has not ceded that responsibility to Avista Energy. [Section VI.]

20 • The Mechanism provides for an objective determination of gas costs as measured against applicable external benchmarks. [Section VII.C.]

21 • The Mechanism provides for a symmetrical sharing of incentives across all primary components of the Mechanism; there is, accordingly, an appropriate balancing and allocation of risks and rewards in a way that does not distort decisionmaking. [Section II.C.]

22 • Each component of the Mechanism is easily auditable; this includes each of the three Tiers of the commodity component, as well as storage and transportation; a Daily Log has been proposed to assist in the auditability of the Mechanism. [Section VII.]

23 • The Mechanism comports with the Commission's Policy Statement on incentive ratemaking, which was designed to promote innovative thinking, and not otherwise serve as a straightjacket. [Section VIII.]

24 • In terms of quantifiable benefits to customers, sound analysis supports $2.6 million of annual benefits to customers through operation of the Mechanism, and approximately $1.0 million per year to Avista Energy (see Exhibit 55C). [Section III.B.]

25 • From Avista Energy's perspective, there is no opportunity to realize unreasonable gains: (a) Avista Energy projects that, under the proposed Mechanism, it will earn only $1.0 to $1.3 million per year, and that includes the $900,000 management fee (see Tr. p. 403, ll. 1-7); (b) indeed, if the proposed Mechanism had been in place since 1999, Avista Energy would have only earned $987,000 per year, which is in keeping with its future projections (see Exhibit 55C); and (c) under the Mechanisms that were actually in place since the inception of the original Mechanism, estimates show that Avista Energy actually lost, on average, $1.1 million per year (see Bench Request No. 1). [Section IX.]

26 • The assumed level of transportation benefits derived from Capacity Releases and Off-System Sales supports the proposed $3 million guarantee, with an 80%/20% sharing thereafter; Public Counsel and Staff have made numerous errors which substantially undermine their analysis: these include the use of a 69 cent per Dekatherm rate for the value of Capacity Releases and Off-System Sales, when the actual realized rate over the past three years was only 22.7 cents; also errors were evident in the use of combined Washington and Idaho figures and the use of incorrect assumptions concerning the availability of excess capacity based on the difference between average (versus peak) load and total contracted for capacity. [Section IV.C.]

27 • Staff's and Public Counsel's conclusions and recommendations related to the following issues, among others, are based on incorrect analysis and/or are not supported by the record:

(1) value of Avista Utilities' available pipeline capacity; [Section IV.C.ii.]
(2) costs to cover daily load variability; [Section IV.A.v.] and
(3) Staff's recommended alternatives to:
  (a) put the Mechanism out for competitive bid;
  (b) increase Capacity Release/Off-System Sales guarantee to $7 million per year and eliminate the $900,000 management fee; and
  (c) assign all transportation rights and costs to Avista Energy and allow Avista Utilities to pay only for the transportation that it needs. [Section V.]

28 • Finally, there is no compelling reason for this Commission to abandon this Mechanism, when its basic structure is not at issue, especially given the current market volatility. The arrangement with Avista Energy provides confidence in reliable supply for Avista Utilities' customers, control and flexibility to make changes to purchasing strategies as necessary over time, built-in incentives to cause Avista Energy to create value and lower overall costs to its customers, and full access to all records at Avista Energy for audit and review. [Section III.A.]

## II. DESCRIPTION OF MECHANISM AND HOW IT WORKS

### A. Introduction.

29 The Company presented its case through the testimony of Witnesses Norwood, Gruber, D'Arienzo and Hirschkorn. Mr. Norwood, as Vice President of State and Federal Regulation, was the policy witness on behalf of the Company and is intimately familiar with the Mechanism, having appeared before this Commission on several occasions to discuss its importance and the objectives being served. Mr. Gruber, as Manager of Natural Gas Resources for Avista Utilities, provided a detailed explanation of the Mechanism and changes that were made in order to address Staff's concerns. He also discusses the benefits provided by Avista Energy and explains why the continuation of the Mechanism is important to the Utility's customers. Mr. Gruber has worked in the utility industry for 36 years and has spent the last 14 years in natural gas supply and planning roles. (Exh. 51, p. 1, ll. 7-14). He is responsible for administrative oversight of the agency agreement with Avista Energy, the long term planning for natural gas resources, federal regulatory oversight, pipeline relations, gas supply oversight and fuel supply for the Utility's natural gas thermal generation. (Id.)

30 Mr. D'Arienzo, for his part, is Vice President of Natural Gas Marketing and Trading for Avista Energy, and, as such, is responsible for the management of natural gas trading and marketing at Avista Energy. He has been with Avista Energy for five years, and prior to that worked for BC Gas from 1993 to 1998; before that he worked for The Washington Water Power Company from 1983 to 1993 – all in the natural gas business. (Exh. 101T, p. 1, ll. 14-17). As noted by Mr. Norwood, together Mr. Gruber and Mr. D'Arienzo "have over 40 years of operating experience in the natural gas industry relating to commodity procurement, transportation and

natural gas storage." (Exh. 3T, p. 18, ll. 7-18). In short, they bring a wealth of experience to this process.

31 The Mechanism itself, once understood, is simple and straightforward. There are three major components. The first component is the Commodity Component, in which gas volumes are purchased under a diversified portfolio approach that attempts to balance the lowest cost supply with some level of price stability. The second component consists of the Jackson Prairie Storage Component, which provides benefits through the optimized operation of the storage project. The third major component is the Capacity Release and Off-System Sales Component, which captures the optimization of all pipeline capacity reserved for the utility customers. (Exh. 1T, p. 3, ll. 13-20).

32 Attached as Appendix B is page 1 of Exhibit 2, consisting of a schematic of the Benchmark Mechanism. It breaks the Mechanism into its three constituent parts: commodity, storage and transportation. It further illustrates that, for the period April 1, 2002 through March 31, 2003, of the total cost of gas of $76.3 million, commodity costs accounted for approximately 76% of the total, while storage costs amounted to 6% and transportation costs accounted for the remaining 18%. Each of these major components will be discussed in detail below.

**B. The Roles of Avista Energy and Avista Utilities**

33 Page 2 of Exhibit 2, also attached as Appendix C, depicts the corporate relationship of Avista Utilities and Avista Energy and lists the major functions that each entity performs, insofar as it relates to providing gas resource management and supply. Under the Mechanism, the Utility continues to provide gas services, such as oversight of the Mechanism for the benefit of customers, resource accounting, and the provision of data and load forecasts for core customers to Avista Energy. The Utility also continues to be responsible for long-term planning and

maintaining pipeline assets in the form of transportation contracts on the various pipelines. On the other hand, the actual execution and procurement of natural gas is provided by Avista Energy, at the direction of the Utility. (Exh. 1T, p. 8, ll. 14-23).

*34* Mr. Gruber elaborates on the services that Avista Energy performs under the Mechanism: Avista Energy assists in procuring the gas volumes under a diversified portfolio approach, wherein there is an 80%/20% sharing of costs and benefits associated with managing the daily variability of loads, as well as optimizing supply from the lowest cost supply basins; this provides an incentive for Avista Energy to achieve the lowest possible cost for reliable supply. With respect to the Jackson Prairie Storage Component, savings are provided to the customers in the form of the differential in price between summer and winter, coverage of peakday requirements, and the ability to meet daily natural gas requirements under certain conditions throughout the seasons. As explained by Mr. Gruber, Avista Energy would guarantee a 100% cycle of injections and withdrawals from Jackson Prairie and the costs and benefits would be shared symmetrically at 80% to customers and 20% to Avista Energy. Finally, with regard to the transportation component, Avista Energy would provide a $3 million guarantee with respect to optimizing Capacity Releases and Off-System Sales for the benefit of customers, with an 80%/20% sharing with respect to any benefits over and above the $3 million. (See Exh. 52, p. 3, l. 4 – p. 4, l. 2).

**C. Proposed Changes To Address Staff's Concerns**

*35* As a result of concerns expressed by Staff, the following are among the more significant changes to the Mechanism: With respect to basin optimization, the Mechanism has been modified so that customers will receive additional benefits from the price differential between supply basins that are not already captured through the supply basin percentage weightings that

are selected by Avista Utilities. Moreover, greater use of storage will be made to cover daily load variations. (As will be discussed below, however, there is a cost associated with the use of storage for this purpose, contrary to Staff's suggestion.) Accordingly, customers will receive the benefits and risks associated with additional injections and withdrawals of storage to cover daily load variations. As will be discussed in greater detail below, modifications have also been also made to assure that the Mechanism is fully auditable by Staff and Intervenors. (Norwood Direct, Exh. 1T, p. 5, ll. 1-19).[3]

*36* In addition, all components of the Mechanism will provide for a symmetrical sharing of risks and rewards on the basis of 80% to customers and 20% to Avista Energy. For example, with respect to the Commodity Component, the difference between daily prices and first-of-month prices for the daily customer load that deviates from monthly estimates will be shared 80%/20%. (Exh. 1T, p. 10, ll. 12-23). In addition, the value from basin optimization, discussed above, will be shared 80%/20% between customers and Avista Energy.[4]

*37* Moreover, with respect to the Storage Component, gains and losses from injections and withdrawals used to cover daily load variability will be shared 80%/20%, as will gains and losses associated with the summer and winter price differential. Finally, as it relates to the Transportation Component, customers will receive 100% of a $3 million guarantee related to Capacity Releases and Off-System Sales; any value received above the $3 million guarantee will be shared 80%/20%. As explained by Mr. Norwood, "by building in symmetrical sharing

[3] Mr. Parvinen agrees that, through time, the mechanism has been adjusted and modified to take into account changed marked conditions, as well as suggestions from staff and others. (Tr. p. 496, ll. 2-6.)

[4] Mr. Norwood explained why there is no 80/20 sharing with respect to Tier 1 transactions:

> . . . There's no sharing around that [Tier 1], and there's no sharing for a reason. The purpose of that one element is to fix the price on that. If you start talking about a sharing, then it unwinds the objective of fixing the price, so there are certain elements where it may not make sense to have a sharing, but on balance, when you look across the whole mechanism, there should be a balancing of risks and rewards, and I think there is here.

(Tr. p. 174, ll. 4-16.)

incentives equally across all of the components, i.e., 80%/20% sharing on each component, it encourages Avista Energy to drive value from each component, and not favor one over the other." (Exh. 1T, p. 11, ll. 10-12).

**D. Substantial Agreement Exists Around The Basic Elements Of The Mechanism**

38 Notwithstanding substantial agreement with Staff around the basic contours of the Benchmark Mechanism, Staff, nevertheless, surprisingly recommends, among its alternatives, the termination of the Mechanism. This is all the more remarkable given the amount of apparent agreement reached over time around the basic structure of the Mechanism. As explained by Mr. Norwood in his rebuttal testimony (Exh. 3T, p. 6, ll. 10-22), there appears to be general agreement around:

39 (1) A tiered purchasing strategy: Tier 1 hedges at 50% of total estimated load, Tier 2 natural gas purchases are set at First-of-Month (FOM) index pricing for the remaining 50% of the estimated monthly load, and Tier 3 reflects intra-month daily load volatility with storage and daily pricing;

40 (2) Use of Jackson Prairie Storage to capture summer/winter price differentials and coverage of peak days, as well as to manage daily load swings when economically feasible without sacrificing reliability;

41 (3) Use of pipeline Capacity Releases and Off-System Sales to gain additional value for customers;

42 (4) Optimization of supply basin price differentials for the benefit of customers;

43 (5) Reduction of price fluctuations and risk for Avista Utilities through the purchasing strategy; and

44 (6) The alignment of interests of Avista Energy and Avista Utilities' customers in such a way that Avista Energy is only rewarded when customers benefit.

45 If anything, the history of this Mechanism has demonstrated its adaptability to changing conditions. The issues identified in this case do not warrant termination of the Mechanism.

46 In response to questions from Commissioner Hemstad, Mr. Norwood stressed that the environment has changed since the Mechanism was first implemented, with regard to factors such as price volatility and counterparty risk, with the result that there is an even greater need now for Avista Energy's participation. (Tr. p. 233, ll. 5-21).

## III. BENEFITS OF THE MECHANISM TO CUSTOMERS

### A. Benefits From Avista Energy's Greater Market Presence

47 Company Witness Norwood summarizes the many advantages of Avista Energy's involvement on the Utility's behalf in procuring commodity, and managing transportation and storage services:

> 48 Through consolidation of the Company's gas procurement functions under Avista Energy, Avista Energy has been able to pool Avista Utilities' supply, storage and transportation arrangements with their portfolio. This has provided Utility customers additional benefits from Avista Energy's operations, while avoiding many of the risks. Avista Energy has been able to provide expertise, sophisticated tools, involvement in a broader geographic market and a broader customer base than Avista Utilities could provide. This has resulted in lower costs to customers than was possible under Avista Utilities' smaller-scale natural gas procurement operations, given a similar gas purchase/optimization strategy.

49 (Exh. 1T, p. 7, ll. 13-21). The benefits, therefore, that customers enjoy are premised on Avista Energy's greater presence in the market for commodity, transportation and storage services. Mr. Parvinen, on behalf of Staff, has it backwards when he asserts that "access to these valuable assets provides economies of scale and market presence to Avista Energy." (Exh. 201T, p. 52, ll. 11-12). It is, in fact, Avista Utilities that benefits from the size and scope of Avista Energy's

involvement in the natural gas markets; Avista Utilities' natural gas volumes managed by Avista Energy, in fact, amounted to less than 3% of Avista Energy's total business. (Exh. 3T, p. 3, ll. 8-13). Stated differently, Avista Energy actually provides Avista Utilities with "market presence," with the result that customers receive the benefits intrinsic to being part of a significantly larger natural gas portfolio. (Id.)

50 On cross-examination, Mr. Norwood analogized Avista Energy's participation to that of a Wal-Mart:

> 51 Avista Energy is, in essence, like a Wal-Mart, where they have access to a lot of suppliers, they move a lot of volume, and so they know what the market is. The suppliers are willing to do business with them very quickly because they do a lot of business with them, and so they have the pulse of the market, and so they are able to execute these transactions a lot easier than what we are.
>
> 52 What they also do is they are taking on the, number 1, deliverability. It's up to them to make sure that the supplier delivers. If they don't deliver, it's Avista Energy's problem, not the Utility's problem. If the counter-party does not pay their bill, then it's Avista Energy's problem, not our problem. If they ask the Company to post collateral, it's Avista Energy's problem, not ours. So there's a lot of those things that their handling in dealing with that the Utility no longer is through this mechanism.

(Tr. p. 215, l. 20 – p. 216, l. 13).

53 Exhibit 52, page 1, provides a catalog of the benefits provided to Avista Utilities' customers by virtue of Avista Energy's participation: Avista Energy's participation leads to economies of scale, deriving from Avista Energy's expertise, its access to a larger customer base, its sophisticated planning tools and its access to additional markets and efficient administration. Secondly, Avista Energy's involvement allows for mitigation of risk around currency, gas daily volatility, credit, counter-party concerns, and nomination errors. Thirdly, with respect to storage, Avista Energy provides a 100% cycle guarantee, and its management of storage provides additional operating flexibility to use the resource as a partial hedge during extremely cold

weather events. Fourthly, Avista Energy assists in pipeline optimization, allowing for efficient utilization of available capacity. All of the above translate into lower costs to customers than would be possible given Avista Utilities' smaller scale of natural gas procurement operations.

54 As will be discussed below, the Company has provided a detailed analysis of the benefits to Avista Utilities' customers through utilization of the Benchmark Mechanism that approximate $2.6 million annually. (Exh. 3T, p. 3, ll. 16-22). Simply put, as Mr. Norwood testified, "unless there are compelling reasons based on sound analysis and documentation, the Benchmark Mechanism should not be terminated, resulting in a loss of benefits to customers." (Id.) As further testified to by Mr. Norwood, the Benchmark Mechanism is "well-structured, well-thought out and has been refined over time through the experience gained in the operation of the Mechanism over the past four years in Washington, Idaho and Oregon and should be continued." (Id. at p. 4, ll. 17-19). The Mechanism has provided a means for implementing alternative, innovative approaches to gas procurement in a way that will substantially benefit customers.

55 It is also well to recognize that, if anything, risks to Avista Energy have actually increased since the original Mechanism was implemented in 1999. Some of these risks and costs include market liquidity, management of intra-month price volatility, currency and credit risks, and the risk of nonpayment by counterparties. (Exh. 1T, p. 9, ll. 7-14). There is, therefore, an even more compelling justification for the Mechanism now, given the volatility in the markets and the allocation of risks and benefits under the Mechanism between Avista Energy and Avista Utilities' customers.

**B. Annual Benefits to Customers Of $2.6 Million Have Been Identified**

56 Company Witness Gruber provided the detail around the estimated benefits of approximately $2.6 million annually to customers, as a result of the Mechanism. Included within

his rebuttal testimony is a side-by-side table that summarizes the benefits, by category, for customers. He has also included, for comparison purposes, the Staffs' calculation of benefits, for ease of reference. That table, excerpted from page 3 of his rebuttal testimony (Exh. 53T), is set forth immediately below:

**Table 1**

**Estimated Annual Incremental Costs Associated with Natural Gas Procurement Managed by the Utility vs. Avista Energy**

| | Avista Utilities Managing Gas Procurement | |
|---|---|---|
| | **Company Table per (RHG-1T)** | **Staff Table per Exhibit (MPP-8)** |
| **Expense Category** | | |
| Employee (loaded labor plus support costs) | $408,500 | $408,500 |
| Credit | $512,500 | $512,500 |
| Premium for Physical Delivery | $123,200 | $123,200 |
| Currency | $176,000 | $ 0 |
| Load Volatility | $231,000 (1) | ($1,759,855) (2) |
| Estimated Loss of Transportation Benefits | $2,000,000 | $ 0 |
| Subtotal of Benefits to Utility Customers | $3,451,200 | ($715,655) |
| Proposed Management Fee | ($900,000) | ($900,000) |
| Net Additional Costs (Benefits) if Procurement Operations were to return to the Utility | $2,551,200 | ($1,615,655) |

(1) This valuation represents the costs associated with the daily swing around the average load due to customer load volatility that is borne by Avista Energy (net of shared total basin optimization benefits).
(2) This valuation is Staff's revision to Avista Energy's estimated share of the daily swing around the average due to customer load volatility (net of shared total basin optimization benefits, winter summer differential, storage peaking benefits, and Capacity Release/Off-System benefits). Costs are positive numbers benefits or savings are in brackets.

57 While the Company has demonstrated annual benefits of approximately $2.6 million, Staff, on the other hand, argues that customers would actually benefit in the amount of $1.6 million, were the procurement operations returned to the Utility. As shown in the Table, the major differences relate to only two areas: (1) "load volatility" – i.e., Tier 3 transactions designed to cover daily load volatility; and (2) transportation benefits – i.e., benefits derived through Capacity Releases and Off-System Sales. Each of these major differences between the Company and Staff will be addressed, in turn. Before doing so, however, some mention should be made of the other expense categories identified in the Table about which there is apparently no dispute or which are relatively small.

58 The first item in the expense category ($408,500) relates to "Employees" and reflects the fact that, were the current Mechanism brought back into the Utility, the incremental administrative costs would involve, at a minimum, four to five additional employees and associated support costs such as training, travel and computers. (Exh. 53T, p. 7, ll. 4-8). The next entry, entitled "Credit" ($512,500) consists of the estimated cost of the credit facility that would enable the Utility to post-collateral in the form of letters of credit or cash with counterparties to allow the Utility to purchase gas for its customers – an expense that the Utility, instead of Avista Energy, would have to bear were this function to return to the Utility. (Id. at p. 8, ll. 11-13).

59 The next item, entitled "Premium for Physical Delivery" ($123,200), relates to the basic fact that gas market trades occur in one of two forms, financial or physical. The fixed price products that are involved with Tier 1 fixed price deliveries to customers are done with financial instruments (hedged transactions). The physical gas for Tiers 1 and 2 is then purchased at First of Month index, which is a physical product. In order to assure availability of physical deliveries, it

is necessary to purchase an index product at a premium, as testified to by Mr. Gruber. (Id. at p. 8, ll. 14-19).

60 The next item, although relatively small and about which there is some dispute, relates to "Currency Risk" ($176,000). This entry is necessary because of the fact that a large portion of the supply is based at AECO (in Canada), and AECO trades almost exclusively in Canadian dollars. Accordingly, Avista is exposed to the continuing risk of changes in the exchange rate between U.S. and Canadian currency. (Id. at p. 8, l. 21 – p. 9, l. 3). While not a major component of the cost-benefit analysis, Staff and the Company do differ with respect to the entry entitled "Currency Risk." Staff proposes to reduce the cost associated with hedging against "Currency Risk" from $176,000 to zero asserting that "as a matter of logic this item should be zero because there should be an equal chance of currency changes both up and down." (Exh. 201T, p. 32, l. 15).

61 Actual experience, however belies this assertion. As explained by Mr. Gruber, our historical experience with currency exchange has shown a net cost to the Company, as detailed in supporting workpapers which show that the cost exposure is approximately 1 cent per Dth purchased in Alberta, equating to approximately $176,000 per year. (Exh. 53T, p. 12, ll. 13-25). The fact remains that currency rates "go up and down and if the desire is some stability in pricing, currency exchange rates can and should be hedged," as explained by Mr. Gruber. (Id.) The Company's estimate of the cost to hedge against such exposure is reasonable and should be reflected as a cost to providing service under the Benchmark Mechanism. Indeed, in response to Chairwoman Showalter, Staff witness Parvinen acknowledges that the avoidance of currency risk has a value:

Q: Does avoidance of risk have a value?

A: That's a tough question. I guess, yes, it would have a value. It would have – that value would have to be weighed against the cost.

(Tr. p. 502, ll. 4-7.)

62 As mentioned above, the primary differences in the Table above relate to "load volatility" and "estimated loss of transportation benefits," both of which will be discussed in detail below in Sections IV.A.v. and IV.C, respectively. Finally, there is the "proposed management fee" of $900,000. The current Mechanism contains an adder for Avista Energy which is set at 5 cents per Dekatherm on all volumes.[5] Because the market has changed substantially since the inception of the Mechanism and its 5 cent "adder," the Company is now proposing a $900,000 management fee to be paid annually to Avista Energy in order to cover some of the costs and risks that have been described above. In addition, Avista Energy has a performance based incentive through the 80%/20% symmetrical sharing built into the Company's proposal.

## IV. A REVIEW OF THE MAJOR COMPONENTS

### A. The Commodity Component

63 Acquisition and pricing for commodity is set up in three separate tiers. Included as Appendix D to this Brief is Exhibit 4, consisting of a bar graph depicting the various Tiers. It reflects Tier 1 purchases made during the year to lock in the price on 50% of the load; Tier 2 purchases at First of Month index price on a month ahead basis to address the remaining 50% of the estimated load; and Tier 3 daily purchases and sales to cover daily load variability.

#### (i) Tier 1

64 Tier 1 is designed to approximate the minimum load one would see in any month. As explained by Company Witness Gruber, this minimum load is satisfied by using a "combination

[5] This 5 cent "adder" was developed as a surrogate for the amount above index that the Utility had been able to purchase gas for historically, given the low annual load factor inherent with temperature sensitive core demands, as explained by Mr. Gruber. (Exh. 51T, p. 9, ll. 10-21).

of fixed price gas purchases and base load storage, which are both essentially fixed price products." (Exh. 51T, p. 11, ll. 11-20). This first tier represents approximately 50% of the average daily core load each month and can be conceptualized as the first layer of supply needed to serve our customers' average load each month. (Id.)[6]

*65* It is important to recognize that a Strategic Oversight Group, comprised of representatives from the Utility and Avista Energy,[7] meets periodically to arrange for hedge products for future purchases with respect to Tier 1. In the process, this Group reviews a number of elements that could have an impact on the forward price of gas, including seasonal nationwide storage refill levels, regional pipeline expansion projects, long term weather forecasts, the world price of oil, and the price of forward contracts on the New York Mercantile Exchange, all as explained by Mr. Gruber. (Exh. 51T, p. 12, ll. 1-7). For its part, Avista Energy executes the Tier 1 fixed price transactions in accordance with the guidance provided by the Strategic Oversight Group. (Id.)

**(ii) Tier 2**

*66* Tier 2 represents a fixed volume equal to the remaining 50% of the estimated average customer load each month. It is priced based on the First of Month (FOM) index. Accordingly, when combined, Tier 1 and Tier 2 will always equal the estimated average customer load each month. In other words, as explained by Mr. Gruber, "prior to entering each month, purchases have already been made, representing a total of Tier 1, Tier 2, plus planned storage withdrawals

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[6] While the fixed price base in Tier 1 provides price stability to customers, as explained by Mr. Gruber, it does not always provide the lowest cost. In order to provide the best fixed price benefit to customers, the Company spreads the acquisition of fixed price products out over the season generally between mid-February and mid-November. (Exh. 51T, p. 11, ll. 17-20).

[7] This Group will be explained in more detail later.

that are equal to the estimated average load for the upcoming month." (Exh. 51T, p. 12, ll. 12-16).

**(iii) Tier 3**

67 While Tiers 1 and 2 are designed to meet estimated average customer load, to the extent that daily load within the month differs from the previously estimated average load, it is necessary to arrange, through Tier 3 transactions, daily purchases or sales in order to balance actual total supply with actual total load. Therefore, Tier 3 is designed to cover only the daily load variations from the estimated average load. Put into context, it represents at most approximately plus or minus 8% of the total annual load for Avista Utilities' customers. (Exh. 51T, p. 12, ll. 17-21).

68 It is important to recognize that all daily purchase volumes under Tier 3 will be delivered to the Utility at Avista Energy's actual average purchase cost for the day. (Id. at p. 13, ll. 1-7).[8] Stated differently, the pricing for these daily purchases or sales will always be equal to the actual average purchase or average sales price, as appropriate, for the day at each supply basin; if there are no transactions at a specific basin, the Gas Daily published daily index for that basin will set the daily price. (Id.) And again, the Tier 3 gains or losses are shared on an 80%/20% basis between Avista Energy and Avista Utilities' customers.[9]

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[8] Witness Elder's analysis of purchasing gas only at first of the month index prices purported to demonstrate that the cost would have been $.75 per MMBTU lower. Chairwoman Showalter correctly diagnosed that exercise as "classic hindsight." (Tr. p. 467, l. 14 – p. 468, l. 18.) Ms. Elder did acknowledge that her analysis also covered the period of price spikes in November and December of 2000 – a period characterized by "extraordinary prices" – and acknowledged that "in that context, seventy-five cents may not be so bad, but it's a lot – from my personal perspective, it's a lot to swallow." (Tr., p. 470, ll. 1-10.) Furthermore, Ms. Elder clarified that she is not recommending that the utility buy all of its gas at first of the month indexes, recognizing that it would subject the utility to volatility. (Tr., p. 473, ll. 15-25.)

[9] The gains or losses are calculated as the difference between the FOM (First of Month) index set in Tier 2 and the average actual daily pricing experienced in Tier 3, times the respective Tier 3 sales or purchase volumes. (Exh. 51T, p. 13, ll. 10-12).

69 Storage can also be used to substitute for daily purchases or sales in Tier 3. In fact, this is another area in which the Company has accommodated concerns expressed by Staff, in order to make greater use of storage to cover daily load fluctuations. As explained by Mr. Gruber, the decision to use storage will be based on the current day pricing and the estimated cost to replace storage at a future time. [10] The decision to use storage will also include an analysis of the deliverability decline from Jackson Prairie and the need to have deliverability on hand to cover peak day demands throughout the season. (Id.)

70 Staff Witness Parvinen raises questions in his testimony about whether commodity transactions are at the "lower of cost or market." (Exh. 201T, p. 6, ll. 9-13). It should first be noted that the transactions at issue involve Tier 3, and therefore relate to only a relatively small volume on an annual basis, which is required to balance load on a day to day basis. Furthermore, as explained by Mr. Norwood, the price to Avista's customers for these daily volumes is the average cost to Avista Energy from the market on the respective day. (Exh. 3T, p. 12, ll. 3-15). According to Mr. Norwood:

71 > From an operating standpoint, once you reach the current day and there is an imbalance for the day, apart from storage, there is no place to go but to the daily market to purchase to meet the deficit, or sell to eliminate the surplus. Therefore, the concerns that Mr. Parvinen raise regarding the lower of cost or market are related to "form" and not "substance," because any dollar differences related to attempting to trace specific therms delivered to the Utility back to specific market transactions for the day, versus simply using the average market price for the day, would be immaterial.

72 (Id.) In fact, Avista Energy conducted an analysis comparing their average daily purchases and sales prices with the Gas Daily published indices for the year 2002, and found that there was no

[10] For Avista Utilities to, itself, somehow hedge Tier 3 transactions, the cost would be substantial, even if one could find counter-parties who would be willing to participate. As explained by Mr. Gruber, Avista Energy is in a better position than Avista Utilities to manage these daily load swings. As he explained, ". . . because they [Avista Energy] are so large, because they are in the market everyday, trading, both buying and selling in the various basins, they have the ability to cover those swings for us." (Tr. p. 328, ll. 4-8).

significant variance between the two. (Id.) In other words, essentially Avista Energy's "cost" is "at the market," as defined by Gas Daily published indices.[11]

73 Moreover, Staff Witness Parvinen's discussion of mark-to-market accounting is irrelevant. As explained by Company Witness D'Arienzo, Avista Energy's utilization of mark-to-market accounting is not pertinent, "since the utility's purchase of supplies are not based on mark to market, but rather are tied back to fixed purchases (Tier 1), First of Month Index (Tier 2) and Avista Energy's average purchases or sales on the day for Tier 3." (Exh. 102T, p. 11, ll. 17-19). He further explained how each of the Tier 1, 2 and 3 transactions are auditable and are based on actual costs. (Tr. p. 392, ll. 6-22).

**(iv) Basin Optimization, As Proposed, Allows for Opportunity to Capture Price Differentials on a Day-to-Day Basis, Based on Appropriate Incentives**

74 Natural gas supplies for Avista Utilities are acquired from three supply basins: AECO (Alberta), Sumas (British Columbia) and the Rockies (Domestic) supply basins. As such, the Commodity Component will continue to be priced based on weighted average purchases from these basins – i.e., Tier 1 fixed price purchases and injections for storage, Tier 2 FOM index purchases and Tier 3 daily purchases and sales. (Gruber Direct, Exh. 51T, p. 14, ll. 12-21). The basin weightings are designed to represent supplies and transportation available to the Utility from each supply basin. As shown on page 4 of Exhibit 52, attached for ease of reference to this Brief as Appendix E, the basin weightings reflect the amount of deliverable transportation

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[11] Mr. Parvinen also suggests that the National Association of Regulatory Utility Commissioners (NARUC) adopted a resolution endorsing a lower of cost or market standard. (Exh. 201T, pp. 19-20). The quoted excerpt from the NARUC Resolution also includes the language, "under appropriate circumstances, prices could be based on incremental cost or other pricing mechanisms as determined by the regulator." (See Norwood Rebuttal, Exh. 3T, p. 11, ll. 18-23). Accordingly, the NARUC Resolution does not, on its face, require the lower of cost or market standard; instead, it allows deference to individual commissions to authorize a mechanism suitable for their utilities. (Id.)

capacity from each basin. These weightings are set on or before February 1st of each year and are effective for the 12 month period that begins the next November 1st.[12]

75 How then, does Avista optimize its use of basins? As explained by Mr. Gruber, basin weightings are based on peak day availability. Therefore, there are days in which the percentage of actual purchases and transportation from the lowest cost basin can be increased. According to Mr. Gruber, this "provides additional opportunity to capture benefits from the price differential between supply basins that is not already captured through the supply basin percentage weightings." (Id. at p. 15, ll. 5-13). As explained by Mr. Norwood, the basin optimization percentages (established by February 1st of each year) are established early on in order to allow planning for Tier 1 purchases. If the prices change between basins – i.e., providing the opportunity for basin optimization -- those weightings in the day to day management of the portfolio can be changed. In other words, subject to the maximum availability of transportation from each basin, Avista Energy will purchase as much natural gas as it can at the lowest price basin. (Tr. p. 148, l. 6 – p. 149, l. 6). Under the proposed Mechanism, 80% of these benefits will go to Avista Utilities' customers.

76 Mr. D'Arienzo explained that while initial purchases are based on basin weightings, later adjustments are made, on a day to day basis, based on price and reliability. (Tr. p. 411, ll. 4-9). Mr. D'Arienzo further explained how this works:

77 > . . . The first thing is reliability. So I've got to make sure to buy a certain amount of supply from each of these basins to match the transportation, to be able to serve the Utility, to have that reliability, so I'll go out and do that. But then, once I get there – and by getting there, once I get to the month and I'm starting to deliver, if I can bring in Rocky's gas and still have the same reliability, then I'll go ahead and do that, so I rearrange the portfolio.

[12] The basin weighted average cost of gas for 2003/2004 is set at 57% AECO, 25% Rockies and 18% Sumas. (Exh. 51T, p. 15, ll. 1-2).

(Tr. p. 408, l. 19 – p. 409, l. 7).

78 While under the current Mechanism Avista Energy would retain any basin optimization benefits to offset risks associated with covering daily load variability, as part of the revised Mechanism the cost of covering the load swings and the benefits of basin optimization would both be shared between customers and Avista Energy on an 80%/20% basis. This represents, again, a symmetrical sharing of benefits across each element of the Mechanism, including "basin optimization."[13]

79 Both Staff and Public Counsel suggest, however, that there should be more flexibility in setting the supply basin percentage weightings, doing so more frequently than once a year. Company Witness D'Arienzo, however, stresses that nothing should be done, in that regard that would jeopardize reliability of service and he explains that Staff and Public Counsel erroneously assume that there is "100% liquidity and the flexibility to economically perform such [basin weighting] changes." (Exh. 102T, p. 6, l. 6 – p. 7, l. 22).

80 As further explained by Mr. D'Arienzo, the selection of supply basin weighting percentages is the "starting point or foundation for the upcoming operating year upon which many other transactions are layered on top of in order to optimize all the assets of the Utility." (underscore added) (Id.) For example, once the basin weighting percentages are established for the upcoming year, it serves to set the initial estimated volumes that will be delivered from each supply basin to serve load, and therefore, provides a guide for the amount of excess pipeline transportation that is available from each supply basin. That, in turn, allows the Company to plan for pipeline Capacity Releases and Off-System Sales. Moreover, based on that

[13] The existing Mechanism has both a Tier 3 and Tier 4 component, which together represent only the most extreme load swings and are priced at Gas Daily index prices. At present, Tier 4 currently has flexibility to utilize storage to offset high daily costs. In the revised Mechanism, Tiers 3 and 4 have been combined into a single Tier 3. (Exh. 51T, p. 16, ll. 9-13).

"foundation," additional commodity transactions are layered on top to further optimize the pricing differentials between the supply basin – also known as "basin optimization."

*81* In addition, pipeline transportation flexibility must be reserved for the use of Jackson Prairie storage transactions in order to provide service under a variety of load conditions. The aforementioned transactions are often of a longer term duration (e.g., for the full operating year) because such longer term transactions generally yield a higher value. Simply put, because all of these elements are "extremely interrelated," Mr. D'Arienzo asserts that "to change the basin weightings mid-way through the operating year would undermine the opportunity to fully optimize the value of all of the assets." (Id.)

*82* On cross examination, Staff witness Parvinen agrees that once the basin weighting percentages are established for the upcoming year, this serves to provide a guide for the amount of excess pipeline capacity that is available from each supply basin. (Tr., p. 476, ll. 1-5.). He also agrees that this allows the company to plan for longer term pipeline Capacity Releases and Off-System Sales. (Tr., p. 476, ll. 6-8.) Moreover, he agrees that pipeline transportation flexibility needs to be reserved for the use of Jackson Prairie Storage transactions in order to provide service under a variety of load conditions. (Tr., p. 476, ll. 9-13.) He also agrees that longer term capacity releases are generally worth more than short term or near term capacity releases. (Tr., p. 478, ll. 3-7.)

*83* In any event, the value that Staff and Public Counsel want to capture through changing the basin weighting percentages is, in fact, already being captured through other elements of the Benchmark Mechanism. Value received through Basin Optimization and Capacity Release and Off-System Sales are to be shared 80% with customers and 20% with Avista Energy. Because the 80%/20% incentive mechanism is symmetrical across all areas of the Mechanism, this

properly motivates Avista Energy to optimize all of the assets on behalf of Avista's customers. (Id.)

84 Mr. D'Arienzo summarizes his position in opposition to changing basin weightings every six months as follows:

85 > . . . . I am concerned that a change mid-stream on the basin weightings will devalue the long term capacity releases, increase reliability concerns and may create uncertainty, in order to capture a value that is already covered in other areas of the Mechanism. As I explained earlier the change in prices between the supply basins will be captured either through "Basin Optimization" transactions or the Capacity Release/Off-System Sales transactions based on the available transportation. These transactions will capture the majority of the value that Staff is focusing on, while preserving the value from long-term capacity releases discussed earlier, as well as preserving reliability of supply.

(Exh. 102T, p. 13, ll. 11-19).

86 Finally, it should be recognized that, previously, Avista Energy was absorbing a lot of the risk in connection with Tier 3 daily volatility, and their "compensation for that was the opportunity to capture the basin optimization," as noted by Mr. Norwood. (Tr. p. 150, ll. 1-4). Under the proposed Mechanism, there will be an 80/20 sharing of the benefits of basin optimization. As explained by Mr. Norwood, the Company, in response to Staff's desire to capture the basin differential, provided for an 80/20 sharing of basin optimization benefits, but in so doing, also made that same 80/20 sharing applicable to Tier 3 transactions for daily load variability, in order to balance the risks and rewards. (Tr. p. 150, ll. 18-23). Accordingly, Mr. Norwood freely acknowledged that Avista Energy received total basin optimization benefits from the inception of the Mechanism through February of 2003 (see Exhibit 55-C) in the approximate amount of $3.87 million.

87 Bench Request No. 1, attached as Appendix F, however, provides an estimate of the costs and benefits under the actual Mechanisms that were in place during the period September 1999

through February 2003, demonstrating that even though Avista Energy previously retained all basin optimization benefits, they also absorbed the costs associated with daily load volatility. (See Tr. p. 154, ll. 2-10). The figures on Bench Request No. 1 show that although Avista Energy gained benefits in the more recent period, they absorbed substantial costs in the early years of the Mechanism, and on average since the inception of the Mechanism, Avista Energy has lost approximately $1.1 million per year. As stated earlier, under the proposed "preferred" Mechanism, there would be an 80%/20% sharing on both the cost of the daily load variability and the benefits of basin optimization.

**(v.) Load Volatility: Staff Is Wrong To Assume That There Is No Cost To Meet The Tier 3 Daily Load Volatility**

*88* Staff has suggested in its testimony that there is absolutely no cost associated with covering the daily swings in customers' loads. Through Staff's adjustment of a negative $1,759,855 in Table 1 above, page 15, it is proposing that there is no cost to cover this daily load volatility. Staff argues that Avista failed to take into account the ability to use storage to mitigate daily load volatility. (See Parvinen Testimony, Exh. 201T, p. 33, ll. 3-5). Mr. Gruber, on behalf of the Company, proves Mr. Parvinen wrong. According to Mr. Gruber's testimony, the Company did, in fact, include the economic dispatch of storage to mitigate daily purchases in its analysis. This entry was labeled as a "peaking benefit" under the storage component on confidential work paper number 5 that was provided to Staff; this work paper was submitted as Exhibit 55C. Simply put, this "peaking benefit" is the benefit derived from the use of storage to manage Tier 3 volatility. (See Gruber testimony, Exh. 53T, p. 8, ll. 8-24). In fact, there should be little reason for confusion around this point. In the Company's direct filing, Mr. Gruber stated that "storage would also be used to mitigate high daily prices and cover some load swings with a

primary focus on maintaining deliverability for peak day reliability because approximately one-third of core peak day requirements are covered with storage." (Exh. 51T, p. 4, ll. 9-13).

89 In fact, Mr. Parvinen has compounded his error by "double counting" the benefits of the use of storage: As explained by Mr. Gruber, Staff included the benefits from this use of storage in two places in its analysis, once to reduce load volatility to zero, and a second time to account for the storage peaking benefit. (See Parvinen Exh. 209C, ll. 3 and 5). (Gruber Rebuttal at Exh. 53T, p. 8, ll. 21-24). In addition, Mr. Parvinen simply uses his "judgment" in support of his assumption that the cost to serve daily load volatility is zero, doing so without the benefit of specific analysis. Beginning at page 33, line 18 of his testimony (Exh. 201T), Mr. Parvinen states:

90 > Because every day of every month will not be average, in some months there will be no space in storage to physically inject gas. Likewise, there will be times when stored gas will be unavailable for withdrawal. On the other hand there will also be times when gas will not be injected because it can be sold at a higher price than the FOM index price. At other times, gas will not be withdrawn from storage to meet the daily load volatility, because it can be bought more cheaply than the FOM index price. In my analysis, I assume these "positive" situations can offset the times when physical constraints on storage create actual cost beyond the FOM index.

91 (Emphasis added). And yet, in response to Avista's data request Number 1 (see Exh. 56), Mr. Parvinen acknowledged:

92 > . . . In his [Mr. Parvinen's] judgment, there are situations in which a net benefit occurs that can offset those situations when a net cost occurs. To form his judgment, Mr. Parvinen made no specific calculation to measure the positive situations described in his testimony. (Emphasis added).

Simply put, the Staff has simply "zeroed-out" the total cost to cover Tier 3 load volatility. This ignores the fact that the total cost to cover this load volatility is approximately $2.3 million per year as supported by detailed calculations provided by the Company, which were introduced as Exhibit 55C. (See also Gruber Rebuttal, Exh. 53T, p. 9, ll. 28-31).

93 In the final analysis, Staff has ignored basic principles of "supply and demand," as explained by Mr. Gruber:

94 > . . . In general terms, for daily load balancing, the Company must purchase in a higher-priced market to cover the higher costs, and must sell its surplus daily gas in a lower-priced market which results in a net cost to cover this daily load volatility. That is the unfortunate reality of the economics of supply and demand. As I stated earlier, the Company has provided extensive analysis to support the estimated annual cost of $2.3 million, as shown on line 3 of Exhibit 55C, to cover this daily load volatility.

(Exh. 53T, p. 11, ll. 3-9).

95 Mr. D'Arienzo, on behalf of the Company, also presented testimony rebutting Staff's assertion that the costs associated with daily load balancing is zero. He explained that Avista had reviewed all possible scenarios with respect to price and load during the operation of the Benchmark Mechanism from September 1999 to February 2003, which scenarios include situations where (1) load and price decrease; (2) load decreases and price increases; (3) load increases and price decreases; and (4) load and price both increase. As explained by Mr. D'Arienzo, the cost associated with scenarios 1 and 4, involving protection from daily price volatility through use of storage drastically outweigh the benefits in the other two scenarios – i.e., by approximately $7.9 million. (Exh. 102T, p. 9, ll. 21-23).

96 During examination by Chairwoman Showalter, witness Parvinen acknowledged that $7.9 million would be a cost to the utility if the Mechanism were to revert back to the utility:

> Q: . . . so if we had used this mechanism in the past, then you are saying some of these numbers would show up as a cost to the utility.
> A: It would show up as a net cost, yes.
>
> Q: Okay. But I guess my – I was just trying to get a judgment from you whether you agree with this table.
> A: If you are looking at it from the Utilities' standpoint, if the Utility were to pick up this benchmark and buy and sell its Tier 3 supplies as proposed – as demonstrated here in the daily market, the $7.9 would be an additional

> cost, it's shown as a benefit because currently Avista Energy would be doing that so it would be a benefit to the utility.

97 (Tr. p. 514, l. 13-p. 515, l. 2.) Moreover, the so-called "positive occurrences" do not offset the "negative occurrences" as assumed by Mr. Parvinen in the process of applying his "judgment." (Id.) Stated differently, the Company supplied detailed analysis of the costs of addressing load volatility, which analysis stands in stark contrast to Mr. Parvinen's facile assumption that there is no cost to cover Tier 3 load volatility.

98 On cross-examination, Chairwoman Showalter also explored with Mr. Parvinen whether or not there were opportunity costs associated with using storage supply to balance load.

> Q: But that doesn't mean there is not an opportunity cost there. One way or another, you either have – you forego your opportunity to use that supply for some other purpose on the market or you preserve that opportunity and buy a hedge of some other kind. I think what I'm trying to get at is there is not a zero cost to balancing load.
> A: Right.

99 (Tr. p. 504, ll. 7-14.) In short, one should not simply substitute Mr. Parvinen's "judgment" (that ignores the "opportunity costs" of storage) for the sound analysis performed by the Company demonstrating that there is a cost to serve daily load volatility.

**B. Storage**

100 It should be recalled that the storage component of the Mechanism accounts for approximately 10% of the annual supply for the Utility core load. (Exh. 51T, p. 17, ll. 10-22). (See also p. 3 of Exh. 52). As proposed, customers will share in the seasonable benefit of a 100% cycle in the storage project with gas purchased at First of Month index pricing in the summer and withdrawn in the winter months to offset the higher cost of winter supplies. In this manner, the winter/summer price differential is captured, while at the same time providing for reliability of peak day demand coverage for utility customers. As explained by Mr. Gruber, the Company has

incorporated a considerable amount of flexibility in storage withdrawals under the proposed Mechanism, to allow for preserving reliability of peak day demand coverage for customers. This covers load swings and offsets otherwise more costly Tier 3 supplies – and yet still achieves the benefits of a 100% cycle summer/winter price differential. (Id. at p. 18, ll. 1-10).

101 The primary cost saving benefit for customers from storage is the ability, in the final analysis, to capture the summer/winter price differential. Mr. Gruber explains how the symmetrical 80%/20% sharing of benefits and risks occurs, in connection with storage:

102 > The synthetic schedule for injections and withdrawals will remain as an aggregate benchmark. Avista Energy will have the flexibility to inject earlier or later than the synthetic schedule as long as the operating tariff schedule for the Jackson Prairie Storage facility is met. If the actual weighted average cost at the end of the injection season is above or below the aggregate benchmark WACOG set by the synthetic injection schedule at FOM, the customers will share 80%/20%, thereby enjoying 80% of the savings and being protected from 20% of the losses that may have occurred. Likewise, if other storage opportunities occur that are consistent with the injection contract requirements and the need for reliability of peak day deliverability, the customers will share 80%/20%.

103 (Id. at p. 19, ll. 6-15). One should not assume that Avista Energy will always benefit through the 80/20 sharing of risks and rewards with regards to storage. Mr. Norwood testified that during two of the last four years, winter natural gas prices were lower than summer prices, which means that Avista Energy would absorb 20% of the cost of the summer/winter differential rather than receive benefits. (Tr. p. 179, l. 19 – p. 180, l. 6).

104 Mr. Norwood also explained why it would not be appropriate to look at just one element of the Mechanism without also looking at the interplay between all of the components and the potential for sharing of risks and rewards:

105 > . . . You can't just look at one element and say that the element is inappropriate because there is no sharing of else there is a higher probability of gains. Let me give you an example. Tier 3 is covering the daily load variability. And if you look at the numbers for the past four years, that is a net cost, and so in your example of 90/10, there's at least a 90% probability that over time that is going to cost Avista

> Energy money, and they recognize that. We recognize that. That's part of the package.
>
> There are other elements of the mechanism where there is a higher probability that they will make some money on that. And so you have to look at all of the pieces and balance them out and see, on average, then, what is the expectation of benefit to Avista Energy and to Utility customers. In all the analyses that we have done shows, on average, Avista Energy is expected to make about a million dollars per year and Avista Utilities' customers about $2.6 million per year. Now the different elements are going to work differently.

*106*

(Emphasis added) (Tr. p. 176, l. 9 – p. 177, l. 5).[14]/[15]

## C. Transportation (Capacity Release/Off-System Sales)

### (i) Avista Energy is Better-Positioned to Manage

*107* The Transportation Component is also referred to as "Capacity Release/Off-System Sales," inasmuch as those are the two primary tools used in managing this asset. As explained by Company Witness Gruber, Avista Energy optimizes the Company's underutilized transportation capacity either by (i) making Capacity Releases to third party replacement shippers, or (ii) by

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[14] Mr. Norwood, in response to Chairwoman Showalter, acknowledged that while there may be a greater probability that Avista Energy will benefit under certain components (e.g., storage), there is a higher probability of it going the other way with respect to Tier 3 transactions where

> There's a high probability that Avista Energy is going to lose money. . . . So there are a couple of items where you don't know for sure which way they are going to go, but some of them have a greater probability than others. Then you have to step back and look at the magnitude. What is the magnitude of the exposure or the benefit to Avista Energy and the Utility and we've tried to balance those out.

(Tr. p. 203, l. 18 – p. 204, l. 12).

[15] Mr. Norwood also stressed the interrelationship, in response to questions from Chairwoman Showalter, between where the transportation guarantee is set ($3 million versus some other level) and the risks associated with the commodity side. On the commodity side, he observed that "the cost to cover that daily volatility is really a one-way deal on average. It actually costs you more to cover that volatility than the money you can make by selling off the excess if your loads are below that." (Tr. p. 208, ll. 19-23). So if one were to change the 80/20 sharing to, for example 50/50, this would increase Avista Energy's exposure which, in turn, would suggest that the level of guarantee on the transportation component would have to be set lower in order to make all the elements equal and fair. (Tr. p. 208, ll. 19 – p. 209, l. 9). Therefore, as testified to by Mr. Norwood, "when you start playing with a 50/50 or a 70/30 or putting the guarantee at a different level, it changes the result, and that's the balancing act that you get into." (Tr. p. 209, l. 24 – p. 210, l. 3).

using the capacity to move gas to others in the form of Off-System Sales. (Exh. 51T, p. 20, ll. 7-20). Customers receive the benefit of Capacity Releases through credits received from the pipeline in the form of a reduction in the transportation expense; Off-System Sales, are also credited to customers by calculating the difference in the daily index pricing between the receipt point of the gas and the delivery point of the gas. (Exh. 51T, p. 20, ll. 15-18). As proposed, the Mechanism would have Avista Energy "guarantee" benefits to customers of $3 million per year, with an 80%/20% sharing mechanism applicable to all dollars beyond $3 million. (Id.)[16]

*108* Mr. D'Arienzo explains why Avista Energy is in a better position to manage this transportation component:

*109*

> AE can provide substantially more benefits to customers than the Utility could provide. This is because: 1) AE has a different risk profile than the Utility, and 2) AE is a very active participant in the market. These two factors provide for a greater number of opportunities and more creative means to maximize the benefits achieved through the utilization of unused pipeline capacity to make off-system sales. This utilization of the capacity to move physical gas at times has more value than simply releasing the capacity to a third party.

(Exh. 101T, p. 6, ll. 3-10).

**(ii) Staff and Public Counsel Analysis**

*110* Both Staff and Public Counsel make significant errors in their assumptions relating to Capacity Releases and Off-System Sales which serve to substantially overstate the benefits that could be achieved. For her part, Ms. Elder, on behalf of Public Counsel, suggests that Avista Energy should be able to achieve $10 million annually in capacity release revenues. (Exh. 251T,

[16] This should be contrasted with the current Mechanism, whereby customers get 100% of the benefit of the transportation component up to $5 million, but without a guarantee that they will reach that level. Beyond $5 million, customers and Avista Energy would share on a 50%/50% basis. (Exh. 51T, p. 21, ll. 1-4).

p. 13, ll. 3-5).[17] Staff, for its part, assumes the ability to achieve $7 million. (See Parvinen, Exh. 201T, p. 50, ll. 14-15).

*111* Ms. Elder's analysis is flawed for several reasons: First of all, the average customer loads used in her calculation are for our combined Washington and Idaho jurisdictions, which is obviously not the appropriate starting point for a calculation of the basis for Washington capacity release revenues.[18]

*112* Secondly, as explained by Company Witness Gruber, Ms. Elder used the difference between the average load for each month and the total capacity for each of the transportation capacity contracts as being otherwise available for release. This would assume the release of capacity otherwise necessary to cover load swings above average load (during periods of cold weather). As such, she fails to recognize that the capacity necessary to serve these loads must be either retained or, at most, released on only a short notice, recallable basis, as explained by Mr. Gruber. (Id. at p. 5, ll. 3-7).[19] However, on cross, witness Elder would appear to recognize that it is prudent for a utility to retain enough capacity to meet peak load conditions:

> Q: Would it be prudent for a utility to retain enough capacity to meet peak load conditions?

---

[17] It should be recognized that witness Elder has never been directly involved on a day-to-day basis in the purchasing function of natural gas; nor has she been personally and directly involved with the release of pipeline capacity on a day-to-day or short term basis, as a trader; nor has she otherwise been directly involved in arranging for capacity releases on a day-to-day basis. (Tr., p. 447, l. 1 - p. 448, l. 2.)

[18] When asked whether her assumptions included the use of average Tier 1 and Tier 2 loads per day for the combined Washington-Idaho jurisdictions, witness Elder responded that "I do not know off-at this moment." (Tr. p. 451, l. 20 - p. 452, l. 4.)

[19] Moreover, witness Elder assumed that the difference between the average load for each month and the total capacity for each of the transportation capacity contracts would otherwise be available for release. (Tr., p. 452, ll. 11-19.) She simply assumed an additional "10% reserve margin" in order to somehow capture the difference between average load and peak day load:

> Q: So is it your testimony that the reserve margin somehow captures the difference between average load and peak day load?
>
> A: In a general sense, that's what it's intended to do.

(Tr. p. 453, ll. 9-13.) That 10% "reserve margin" is wholly inadequate in the case of a 35%-40% load factor utility such as Avista.

A: It depends.

Q: When would it not be?
A: When would it not be prudent to hold enough capacity peak demand?

Q: Yes.
A: If you were in a market where you had a very strong sense that there were alternative suppliers that you could access via a call option, or if you had storage near your load center, which was under your sole control, it might very well be the case that you could choose to not hold capacity to meet your – interstate pipeline capacity to meet your peak day demand.

Q: Do either of those two assumptions ring true with respect to Avista Utilities, do you know?
A: I don't know for certain.

(Tr. p. 453, l. l4 - p. 454, l. 6.)

113 Thirdly, Ms. Elder's actual calculation of the value of the capacity release is badly skewed. In her Exhibit 254C, she calculates the total capacity release revenue at a unit rate of $0.69 per Dth. (Ms. Elder noted during cross-examination that her actual calculations used $0.72 per Dth) (Tr. P. 456, ll. 19) This dramatically overstates the maximum allowable rate for release. As testified to by Mr. Gruber:

114 FERC regulations and the resulting pipeline tariffs limited the recovery of capacity release revenue to the maximum pipeline tariff, which in Northwest Pipeline's case is currently $0.2760 per Dth.

(Exh. 53T, p. 5, ll. 9-13).

115 While it is true that off-system sales are not capped by FERC regulation, they are certainly impacted by the market, as explained by Mr. Gruber. (Tr. p. 361, ll. 5-22). As a "reality check," Mr. Gruber testified that for the three years ending August of 2002, the "combined recovery on a per Dekatherm basis for both Capacity Releases and Off-System Sales was 22.7 cents." (Emphasis supplied.) (Id.) This represents a weighted average figure based on 13.4 cents for Capacity Releases and 36.1 cents for Off-System Sales. (Tr. p. 361, l. 18 – p. 362, l. 2). The

combined figure of 22.7 cents is roughly a third of what Witness Elder used for purposes of her calculation. Indeed, as explained by Mr. Gruber, if one assumed a 69 cent rate (which is three times higher than actual experience dictates) "pipelines would be building capacity, lots of it, because the market would demand it . . . the additional capacity would typically have a dampening effect on the price spread, flatten the value between basins." (Tr. p. 363, ll. 3-11).

*116* Chairwoman Showalter explored with witness Elder her use of the sixty-nine cent figure for Capacity Releases and Off-System supply:

> Q: . . . In your mind, what's the purpose of this exhibit and your calculations here? What does it demonstrate?
> A: The purpose was to try to explore whether or not three million dollars was roughly in the ballpark of what Avista should expect to retain in terms of capacity release revenues in the market.
>
> Q: And what does it show – bear in mind this is confidential, so I'm not sure – you could point to me what figure instead of three million is the appropriate one, if this calculation shows that.
> A: Well, the calculation shows a number that begins with 1-3.
>
> Q: In the bottom right hand corner?
> A: Correct, in the bottom right hand corner there.
>
> Q: All right, but doesn't that number assume or use a sixty-nine cent figure instead of a combination twenty-seven cents, no limit, weighted by Capacity Release and Off-System supply.
> A: It Uses the 72 kind of number.
>
> Q: All right. Now, if the 72 kind of number is not accurately reflective of potential benefits, why are you using it here, or at least why are you purporting to have this document demonstrate that the potential value's really much greater, much greater than three million?
> A: We focused in preparing the testimony on the average effective cost of the transportation and not the tariff rate.
>
> Q: Okay. So is another way to put all of this is that focusing on the effective rate is not a very good indicator or basis upon which to project potential benefits from optimization?
> A: I think I'll agree with that.

(Tr. p. 459, l. 24 - p. 461, l. 8.)

117 Finally, Public Counsel Witness Elder ignores the obvious. Most local distribution companies such as Avista have an annual load factor of only between 35% and 40% and are "very long on capacity in the off-peak months," as explained by Mr. Gruber. (Id. at p. 5, ll. 14-24). Accordingly, this excess of capacity in the off-peak months (March through October) inevitably results in a downward pressure on the market price of released capacity, giving it a minimum value in the summer. And the same holds true for off-system sales. Therefore, she has "severely overstated the value" that could be captured through the release of available transportation. (Id.) Interestingly enough, Ms. Elder could not provide even a "sense of the magnitude" of excess capacity that now exists in the Northwest. (Tr. p. 450, ll. 1-7.) Moreover, at the time she prepared her testimony in this case, she did not have in mind a number or an order of magnitude with respect to pipeline capacity.

> Q: And at the time, did you have in mind a number or an order of magnitude with respect to excess pipeline capacity?
> A: I'm not sure I needed to do that, no.

(Tr. p. 450, ll. 12-15.)

118 While it is true that Ms. Elder did propose a 30% discount to adjust for poor market conditions due to heating loads dropping off in the summer, that only served to reduce her estimate on capacity release revenue recovery from $13.9 million down to $10 million. Even if we were to otherwise use Ms. Elder's own methodology and correct for only one of her errors by simply substituting FERC's approved maximum rate of $0.27/MMBtu, her $10 million estimate would be reduced to approximately $4 million, which is significantly closer to the $3 million proposed in the Benchmark Mechanism, and certainly much less than $7.5 million proposed by Mr. Parvinen. (See Exh. 103C for a derivation of these numbers.)

119 In the final analysis, neither Mr. Parvinen nor Ms. Elder appropriately recognize the degree of risk that Avista Energy has with respect to the recovery of transportation costs, especially given changed market conditions. As explained by Mr. D'Arienzo:

120 > Today's natural gas market is significantly different than two years ago and the rules and regulations associated with capacity release had been modified which makes it more difficult to recover costs. What they both do not seem to appreciate is that the market sets the value of the capacity based on what is traded at the receipt and delivery points of the transportation corridors. As long as there is a positive differential between the two points, then the transport has value. That value is determined by taking the difference between the two points, minus the variable cost to move the natural gas. The market is extremely efficient and will not pay above that level, which is contrary to what Mr. Parvinen and Ms. Elder propose.

(Exh. 102T, p. 2, ll. 5-13).

**[BEGIN CONFIDENTIAL]**

**(iii) Estimated Level Of Transportation Benefits Are Well Supported.**

121 One of the major differences in the Staff's case from that presented by the Company is that Mr. Parvinen suggests there are no benefits to customers from Avista Energy managing the Capacity Release and Off-System Sales for Avista Utilities. (See Table 1 on Page 15 above, which includes zero dollars on the line labeled "Estimated Loss of Transportation Benefits.") Mr. Parvinen's conclusion, however, is based on an improper comparison of numbers, which can be illustrated by stepping through his analysis that he presented in Exhibit 209C.

122 He contends that the time period analyzed includes two months during the "energy crisis" in which he asserts that Avista Energy was able to capture approximately $10.4 million in net benefits – "an anomaly" that he believes should be excluded from the evaluation. (Exh. 201T, p. 36, l. 16). A flaw in this analysis, however, was identified by Company Witness Gruber, where he pointed out that, while Mr. Parvinen's analysis reduced the benefits that Avista Energy actually accrued during this "anomaly period," he failed to reduce the level of benefits that he

assumed the Utility, itself, would have achieved during this same period. (Exh. 53T, ll. 27 – p. 7, l. 3).

123 Although the following pages are somewhat detailed, this issue represents one of the major differences in the cases presented by the Company and Staff, and warrants careful consideration of the evidence. The following pages will demonstrate that a proper comparison of the numbers will show that Avista Energy can provide additional Capacity Release and Off-System Sales benefits of approximately $2.0 million per year, as compared to Avista Utilities managing the assets.

124 Lines 22-31 from Mr. Parvinen's Exhibit 209 C is reproduced below for ease of reference (some of the line descriptions have been abbreviated or paraphrased for better clarity). The full content of Mr. Parvinen's Exhibit 209C is attached as Appendix G. This Table 2 below shows Mr. Parvinen's analysis to remove the affect of the two-month anomaly during November and December 2000.

**Table 2 (From Exhibit 209C)**

[CONFIDENTIAL]

125 The [CONFIDENTIAL] on Line 22 in Table 2 represents the actual off-system sales benefits achieved by Avista Energy on behalf of Avista Utilities for the approximate three-year period September 1999 through September 2002. On Lines 23-29, Mr. Parvinen removes the actual off-system sales benefits achieved by Avista Energy for November and December 2000 of [CONFIDENTIAL], and replaces it with a total of [CONFIDENTIAL], as shown on Line 30. The [CONFIDENTIAL] is based on an average of the actual benefits during the two months before and two months after November and December 2000, as shown on Lines 25-28 of the Table. Therefore, for the three-year period, Mr. Parvinen reduced the total Off-System Sales benefits achieved by Avista Energy from [CONFIDENTIAL] to [CONFIDENTIAL]. Mr. Parvinen presents this [CONFIDENTIAL] as the normalized level of Off-System Sales benefits that could be provided by Avista Energy during the three-year period.

126 On Exhibit 209C, he then compares this [CONFIDENTIAL] to the Off-System Sales benefits that could have been provided by Avista Utilities if it had been managing the pipeline transportation during the same three-year period. This comparison from Mr. Parvinen's Exhibit 209C is reproduced below for ease of reference (some of the line descriptions have been abbreviated or paraphrased).

**Table 3 (From Exhibit 209C)**

[CONFIDENTIAL]

*127* The total of [CONFIDENTIAL] on Line 11 of Table 3 represents the normalized amount of Off-System Sales that Avista Energy could achieve over the three-year period, adjusted to exclude the benefits from the "anomaly" months of November and December 2000. Lines 12-14 of Table 3 reflect the calculation of [CONFIDENTIAL] of estimated Off-System Sales benefits that Avista Utilities could achieve during the same three-year period. In this comparison, Mr. Parvinen suggests that Avista Energy would achieve [CONFIDENTIAL] less Off-System Sales benefits than Avista Utilities during the three year period, as shown on Line 15. This, however, is an improper comparison. The figure of [CONFIDENTIAL] that he adopted on Lines 12 in Table 3, representing the level of Off-System Sales that could be achieved by Avista Utilities, was provided by Avista, and includes the higher level of benefits that could be achieved during the

November and December 2000 "anomaly" months.[20] (Mr. Gruber, Exhibit 53, Page 6) (Exhibit 214). Therefore, the Avista Utilities' value of [CONFIDENTIAL] includes the benefits from the "anomaly " months, but the Avista Energy value of [CONFIDENTIAL] excludes the value from the "anomaly" months. This results in an "apples" to "oranges" comparison.

*128* To complete his analysis, Mr. Parvinen on Lines 16-18 of Table 3 above, includes a comparison of Capacity Release Revenues for Avista Energy and Avista Utilities, and then calculates a total difference in value between Avista Energy and Avista Utilities for the combined Capacity Releases and Off-System Sales. On an annual basis, Mr. Parvinen suggests that Avista Energy would provide [CONFIDENTIAL] less value than Avista Utilities, as shown on Line 21. This conclusion, however, as noted above, is based on an improper comparison. A proper comparison would either include the "anomaly" months for both Avista Energy and Avista Utilities, or exclude the "anomaly" months for both.

*129* To include the "anomaly" months for both Avista Energy and Avista Utilities would yield the results in Table 4 below (all of the data in Table 4 below is from Mr. Parvinen's Exhibit 209C).

[20] See note at the bottom of Mr. Parvinen's Exhibit 209C which states: "Note: Numbers shown on lines 12, 13,14, 16, 17, 18, and 22 are from Company Workpaper 4."

**Table 4 – Including "Anomaly" Months**

[CONFIDENTIAL]

130 In Table 4 above, both the [CONFIDENTIAL] and [CONFIDENTIAL] figures on Lines 11 and 12 include benefits from the two "anomaly" months. Table 4 shows additional annual benefits from Avista Energy managing the pipeline transportation on behalf of Avista Utilities of approximately $2.0 million per year, consistent with the Company's filing in this case.

131 With regard to a proper comparison that excludes the "anomaly" months for both Avista Energy and Avista Utilities, Exhibit 214 contains estimates of Off-System Sales and Capacity Release revenues for Avista Utilities excluding the "anomaly" months. Excluding the "anomaly" months for both Avista Energy and Avista Utilities would yield the results in Table 5 below.

**Table 5 – Excluding "Anomaly" Months**

[CONFIDENTIAL]

132 In Table 5 above, both the [CONFIDENTIAL] and the [CONFIDENTIAL] figures exclude benefits from the two "anomaly" months. Exhibit 214 also explains the additional adjustments to "Capacity Release Revenues" on Lines 16-17, and "Sales that would not have been made by the utility" on Line 13. Table 5 shows additional annual benefits from Avista Energy managing the pipeline transportation on behalf of Avista Utilities of approximately $1.6 million per year.

133 During cross-examination, Mr. Parvinen acknowledged that Avista Energy does in fact provide benefits to Avista Utilities' customers in managing the pipeline transportation, and cited a figure of $230,000 per year. This low figure, however, is not supported by any analysis introduced into the record in this case, and is well below the annual benefits of $1.6 to $2.0 million supported in the case.

**[END CONFIDENTIAL]**

## V. STAFF'S RECOMMENDED ALTERNATIVES ARE WIDE OF THE MARK

### A. Competitive Bid

134 As its first alternative, Staff recommends that the gas supply management functions currently being provided by Avista Energy be put out for "competitive bid." (Exh. 201T, p. 48). This proposal has a number of shortcomings. As explained by Mr. Gruber, the universe of companies that would be interested in participating in such a process has been reduced in the last three years, given the turmoil in the energy markets, leading Mr. Gruber to conclude that "it would not surprise me if the RFP process received little or no interest." (Exh. 53T, p. 17, ll. 1-16).

135 Secondly, it should be recognized that Avista Energy has invested considerable time and effort over the past four years to fully understand the nuances involved in serving the Utility's load, and in the process, has developed an important base of knowledge. It would take at least as much time for any third party unfamiliar with Avista's load requirements to get up to speed. In the meantime, Avista's customers could be exposed to increased risk and price exposure.

136 Moreover, given its corporate relationship, Avista Energy is particularly mindful of placing the highest level of priority on providing for the reliability of supply. Finally, Avista Energy's cooperative attitude, expressed by its willingness to open all of its books and records to audit, is essential to instilling a sense of confidence in the operation of the Mechanism. Would other third parties who were successful bidders evince the same cooperative and forthright attitude? Only actual experience in dealing with them would answer that question.

137 For his part, Mr. Parvinen agrees that Avista Energy has invested considerable time and effort over the past several years to fully understand the nuances involved in serving the Utility under this Mechanism. He also agrees that in the process, it has developed an important base of

knowledge specific to this utility. (Tr., p. 489, ll. 8-22.) He also acknowledges that there would be "some sort of learning curve" for any other third party, were they to take over Avista Energy's functions. (Tr., p. 491, ll. 1-5.) Moreover, Mr. Parvinen acknowledges that Avista Energy has generally shown a cooperative attitude by its willingness to open its books and records to audit by the staff; and indeed, he did not know of any instances where the staff had been denied a request for information. (Tr., p. 492, l. 21 - p. 493, l. 4.) Mr. Parvinen seemingly acknowledges that, were a third party the successful bidder, thereby displacing Avista Energy under the agency agreement, "auditing of a third party's cost would be a problem. . . ." (Tr., p. 530, ll. 2-3.)[21]

**B. Increased Guarantee Of Transportation Revenues**

*138* Staff, for its part, as an alternative, propose to increase the guaranteed level of Capacity Release/Off-System sales to $7 million per year (instead of $3 million) and eliminate the $900,000 management fee paid to Avista Energy.[22] The appropriate level of Capacity Release and Off-System Sales revenues, given the changes in the marketplace, has been addressed at length in Section III.C, above. The Company explained why the current guarantee of $3 million (plus an 80%/20% symmetrical sharing thereafter) made sense, and why arguments by Staff and Public Counsel for a much higher guarantee by Staff ($7 million) and Public Counsel ($10 million) were unrealistic. This prompted Company Witness Gruber, whose responsibilities include following the market for Capacity Releases and Off-System Sales, to conclude that "the $7 million annual guarantee [proposed by Staff], relative to the as available transportation

[21] From Avista Utilities' point of view, whether a third party is a successful bidder, or whether Avista Energy continues with the mechanism, the issue remains the same – is it a "good deal or not." This was explored by Chairwoman Showalter. (Tr., p. 520, ll. 5-19.) At that point, questions of whether an affiliate is involved and whether a "lower of cost or market" standard should be applied is beside the point. Were a non-affiliated third party involved, that question would not arise.

[22] Staff had also, as part of this alternative, proposed to change the basin weightings every six months, on October 1 and April 1 of each year; the harm done in doing so has been discussed elsewhere in this brief.

capacity would not be possible for any party in the current market environment." (Id. at p. 18, ll. 1-14).[23]

139 Mr. Gruber described the current state of affairs with respect to excess transportation capacity, noting that a number of capacity expansions on Northwest Pipeline and Gas Transmission Northwest have occurred over the last three years in order to serve power plants, some of which will no longer be built.[24] This prompted him to observe that ". . . there is certainly an excess of capacity available in some corridors on the system, and that has a downward impact on what you can recover in transportation through Off-System Sales and Capacity Releases." (Tr. p. 359, ll. 1-5). Mr. Gruber, himself was primarily responsible for administering the capacity release program at the Utility from 1996 through 1999. As a result, he has considerable familiarity with the market for such releases over time. Given changes in the market, however, he estimates that, over the next few years, the level would be in the $4 million to $5 million range. (Tr. p. 359, l. 21 – p. 360, l. 15). He noted the recent pipeline expansions as well as the loss of aluminum load. (Id.) Even $4 million to $5 million is not assured:

> Q: Would Avista Energy, as your agent, have to work to get the $4 million to $5 million level of releases in off-system revenues?
> A: Absolutely.

140 (Emphasis supplied.) (Tr. p. 360, ll. 12-15). Therefore, the historic results for capacity release revenues set forth in Bench Request No. 2 do not reflect changed market conditions.

141 Mr. Norwood commented on why the $3 million guarantee for Capacity Releases and Off-System Sales is an appropriate level. He explained that if, in fact, Avista Energy achieved $6

[23] Mr. Gruber also explained why recent pipeline expansion projects designed to meet the needs of new electric generation construction, and the cancellation of a number of such projects, has left the region with a short-term surplus of capacity. This results in a lower release/off-system sale value for capacity held by Avista. (Exh. 53T, p. 18, ll. 1-4).

million with respect to capacity release revenues, they would get about $600,000 which is only about 10% of the overall value, "which isn't a lot when you compare the value that they're adding to the whole mechanism itself." He noted that the incentive "needs to be meaningful enough for them to do a good job for us." (Tr. p. 259, l. 19 – p. 260, l. 4).

142 Mr. D'Arienzo ultimately concluded that Avista Energy would feel comfortable with a guarantee of between three and four million dollars, as concerns Capacity Release and Off-System Sales. He explained that it is:

143 > . . . just getting harder and harder to capture value in that capacity and – because what happens is the market is very responsive to when it sees value like that. So either people will build and – or figure out other ways to get their gas. . . . and then the way the mechanism is with the 80/20, I get a dollar after we hit that guarantee. And so, if like Mr. Norwood said, if we did six million of the three million guarantee, we are getting about 10%. And so I have had a lot of thought on that and – but I wouldn't be prepared to go anything above four.

(Tr., p. 440, l. 14 - p. 441, l. 21.)

144 And, with reference to Staffs' proposed elimination of the $900,000 management fee, this ignores the Company's analysis demonstrating that the cost of providing the service itself (in lieu of Avista Energy) clearly justifies such a fee given the risks involved. (See Exh. 55C). Again, from Avista Energy's perspective, Mr. D'Arienzo testified that:

145 > By eliminating the $900,000 fee, Mr. Parvinen is discounting the costs associated with credit, currency, scheduling, etc. and replacing it with 'so-called' benefits Avista Energy receives by managing the assets. These costs of doing business, however are not outweighed by theoretical benefits related to managing the assets of Avista Utilities, which as I explained earlier in my testimony are currently less than 3% of Avista Energy's total gas business.

(Exh. 102T, p. 12, ll. 17-23).

[24] Mr. Parvinen, when asked by Chairwoman Showalter about the impact of increased pipeline capacity acknowledged that such "an increase in transportation reduces the value of excess capacity in the near term." (Tr., p. 499, ll. 9-14.)

### C. Assignment Of All Transportation Capacity To Avista Energy

146 Lastly, Staff suggests that the Utility should assign all transportation rights to Avista Energy and then simply have the Utility pay for only the transportation it needs. The effect would be to elevate Avista Utility to a 100% load factor shipper (because it would have a call on all transportation whenever it needed it), even though its annual load factor is in the vicinity of only 35% to 40%. In so doing, as explained by Mr. Gruber, Avista Energy would be required to "accept the risk of holding and paying for capacity the Utility has call rights on without receiving compensation for the call rights, which would be very expensive." (Exh. 53T, p. 18, ll. 18-22). Avista Energy would be essentially providing standby, on-call service at very little cost to the Utility – a completely untenable position.

147 Mr. Parvinen agrees that Avista's annual load factor is in the vicinity of 35-40%. (Tr., p. 493, l. 24 - p. 494, l. 7.) Moreover, he concedes that Avista Energy would essentially be providing "standby on-call service" to meet peak day deliverability at little cost to the utility:

> Q: . . . wouldn't Avista Energy, under the scenario I described, be essentially providing standby on-call service to meet peak day deliverability at virtually no cost to the low load factor utility?
> A: That would be a trade off that it would have for the ability to be able to manage those capacities and collect the revenues for those.

(Tr. p. 494, l. 20 - p. 495, l. 2.)

148 But when asked what would be the cost to Avista Energy of simply holding that capacity in reserve, he acknowledged that the cost would be seven and one-half million dollars. (Tr., p. 495, ll. 20-23.)

## VI. STRATEGIC OVERSIGHT GROUP

149 Mr. Norwood explained that "this is not a situation in which Avista Utilities has turned over the gas procurement functions to Avista Energy and then turned its back hoping that Avista

Energy will do a good job for Avista Utilities' customers." (Emphasis supplied.) (Exh. 3T, p. 2, ll. 6-22). A Strategic Oversight Group, consisting of a team of employees from both Avista Utilities and Avista Energy supervises the operation of the Benchmark Mechanism. Participating in this group from Avista Utilities are the Manager of Natural Gas Resources, the Manager of Risk Management, and representatives from Accounting and Rates. Indeed, Public Counsel Witness Elder has recognized the benefit of this collaborative effort, when she observed that ". . . AE and Avista Utility employees work together in making key decisions on behalf of ratepayers." (Exh. 251T, p. 8).

*150* On re-direct examination, Mr. Gruber elaborated on the "give and take" involved within the Strategic Oversight Group. He also noted that decisions were modified or adjusted as a result of that "give and take" – something which happened "a fair amount of the time." (Tr. p. 354, l. 24 – p. 355, l. 14). He also described the interaction with senior management concerning hedging activity and the amount of discussion that ensues. (Tr. p. 356, ll. 1-7). Mr. Gruber emphasized that the Strategic Oversight Group coordinates with and reports to senior management at the Utility:

*151*

> . . . The results of the . . . Strategic Oversight Group are presented and have been presented a number of times to our senior management, through their risk management committee, which is comprised of our chairman, general counsel, chief financial officer, president of the Utility. It's also presented to the Senior Officer Group through our, what they call operations council.

(Tr. p. 349, ll. 13-21).

*152* Mr. D'Arienzo, in his examination by Commissioner Oshie, provided a flavor of the workings of the Strategic Oversight Group from Avista Energy's perspective. (Tr. p. 427, l. 2 – p. 428, l. 8). Mr. D'Arienzo's job is to come in with "an independent voice" and to recommend,

for example, when we should hedge and when not to. But he stresses that Mr. Gruber is the "ultimate decision maker of the SOG." (Tr. p. 426, ll. 5-11).

153 Lastly, it is important to recognize that the "purchasing strategy is the strategy that would be employed by the Utility if the natural gas procurement functions were housed within Avista Utilities, instead of Avista Energy," as testified to by Mr. Norwood. (Exh. 3T, p. 2, ll. 17-22). Avista Energy, for its part, provides real benefit by carrying out the purchasing strategy and optimizing the transportation and storage assets, at the direction of Avista Utilities, in such a way as to reduce the overall costs. (Id.)

## VII. AUDITABILITY

### A. Each Component Is Easily Auditable

#### (i) Commodity

154 Each of the three tiers of the Commodity Component are easily auditable. With respect to Tier 1, fixed price purchases are made during the year to lock in the price on gas supply which, together with Jackson Prairie Storage withdrawals, addresses approximately 50% of the Utility's average load. These are in the form of specific transactions that are "tagged" by Avista Energy for the Utility and are, as such, directly auditable. (See Norwood Direct, Exh. 1T, p. 12, ll. 13-23). Tier 2, representing the remaining 50% of the Utility's estimated average load, is purchased in advance at First of Month (FOM) index prices. As explained by Mr. Norwood, these are also easily "tagged" and auditable by the Utility. (Id.) Finally, with respect to Tier 3 daily transactions, which form only a relatively small portion of the overall annual volumes (plus or minus 8% of annual volumes), the pricing will be the "average actual daily price of all Avista Energy gas daily purchases on each given day," which the Utility will be able to easily audit. In addition, as explained by Mr. Norwood, a "comparison of this price can be made against the Gas

Daily market index price to ensure it is representative of the daily market price to serve this daily load variability." (Exh. 1T, p. 13, ll. 1-4)[25]

155 It is also important to recognize that the participation of Avista Energy on behalf of the Utility with respect to Tier 3 transactions does not otherwise complicate the issue. As noted by Mr. Norwood, "if natural gas procurement operations were conducted within the Utility instead of Avista Energy, Avista Utilities would experience a cost very similar to that provided by Avista Energy, i.e., a price representative of the daily market price for natural gas." (Id. at p. 13, ll. 9-13). Indeed, Avista Energy conducted an analysis that compared their average daily purchases and sales prices with Gas Daily published indices for the year 2002 and found that there was "no significant variances between the two." (Exh. 3T, p. 12, ll. 12-15). Thus, as shown in Mr. D'Arienzo's Exhibit 105, the analysis of Avista Energy's daily purchases and sales at the three basins from which Avista Utilities purchases its natural gas demonstrated that Avista Energy "transacted essentially at market" on behalf of the Utility. (Exh. 102T, p. 12, ll. 3-7).[26]

156 Of course, the success of any audit process depends on the willingness of the parties to freely share information. In that regard, Mr. D'Arienzo, on behalf of Avista Energy, was quite emphatic in offering up the books and records for purposes of audit:

157 > The books of AE are open for Avista Utilities and Commission Staff to audit. In the past, the Staff has spent time on the floor observing the morning trading activity to get a sense for how AE participates in the market. For the transactions such as fixed price purchases of gas, we have deal tickets, taped lines, counter-party confirms and nucleus computer system reports which track all of AE's trades. Although the information regarding the transactions under the Mechanism will be confidential, it will be available to Avista Utilities and the Staff for their review.

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[25] If Avista Energy does not actually purchase any gas on a given day because they can cover the load with additional gas that they have in their own portfolio, the price of the volumes required by the Utility will be priced at the Gas Daily index for that day. (Exh. 1T, p. 13, ll. 4-7).

[26] It is important to keep in mind the benefits that Avista Energy provides with regard to Tier 3 transactions; including among others the guaranteed coverage of daily loads, management of Storage to cover daily loads when economic and it does not jeopardize reliability, credit risk, and non-payment by counter parties.

158 (Exh. 101T, p. 6, ll. 13-19). Such a cooperative attitude on the part of Avista Energy may not otherwise typify an agency relationship with an unrelated third party, were Avista to contract these services out to someone else. Moreover, Mr. D'Arienzo testified that Avista Energy has never denied a request for additional follow up audit material or documentation from staff; staff has been invited on several occasions to come over "to our shop" – "we've been an open shop." (Tr., p. 436, ll. 6-15.)

**(ii) Storage**

159 Under the Mechanism, storage costs are transaction-specific and are easily tagged and auditable. As explained by Company Witness Gruber, the storage cost components are straightforward, inasmuch as they are based on First of Month index pricing. (Exh. 51T, p. 19, ll. 17-21). Any purchases outside the synthetic storage schedule will be priced at the average price of all of Avista Energy's purchases for each given day, which purchases are auditable because volumes above or below average for the synthetic schedule are readily determinable. (Id.)

**(iii) Transportation**

160 In a fashion similar to storage, benefits received from the Transportation Component are also transaction-specific. This means that each capacity release can be clearly tracked on the pipeline's electronic bulletin board and each off-system sale is documented in a separate confirmation listed on the pipeline's monthly invoice. (Exh. 51T, p. 21, ll. 6-10).

**B. Creation Of A Daily Log To Assist The Audit Process**

161 In addition to all of the underlying source documentation described above, Avista has proposed the creation of a Daily Log to record all Tier 1, Tier 2 and Tier 3 commodity transactions, which will include the external benchmark comparisons on a daily basis. This log will be part of the documentation and audit trail for Avista Utilities and will supplement the

quarterly reports already provided to the Commission. (Exh. 3T, p. 9, ll. 4-10). A sample Daily Log, introduced as Exhibit 5, is appended to this Brief as Appendix H. As indicated, this will be in addition to the quarterly reports already being prepared and provided to the Commission Staff and interested parties. In summary, as testified to by Mr. Norwood, "transparency" has been added to all of the components. (Tr. p. 230, l. 25 – p. 231, l. 2).

**C. External Benchmarks Are Readily Available**

*162* Concerns of Public Counsel over a lack of satisfactory external benchmarks are misplaced. First of all, with respect to the hedging strategies under Tier 1, 50% of the portfolio is purchased at the First of Month (FOM) index prices, which itself serves as an external benchmark. These Tier 1 purchases are typically made six to eighteen months in advance and remain fixed in order to provide a level of price stability for our customers. (Exh. 3T, p. 7, l. 26 – p. 8, l. 10). These Tier 1 purchases are locked in, in advance, by contract and are transaction – specific and, hence, are easily "auditable" against external benchmarks. Contrary to Staff's suggestions, there is, in fact, a benchmark with which to compare Tier 1 transactions. As discussed by Mr. Norwood:

*163*

> . . . That benchmark is the market at the time when the hedges are locked in. And as we lock in these hedges, there will be the actual contract itself, together with other market information as to what the price was at the time, and that would be the benchmark against which we can compare the price that is locked in.

(Tr. p. 121, ll. 4-10).[27]

*164* With respect to Tier 2 transactions, which constitute the remaining 50% of the estimated monthly load, purchases are made at First of Month index prices, which again serve as the

[27] For purposes of the benchmark, there would be broker quotes available from a number of marketers or suppliers at the time the hedges were entered into, and documentation of the prices available at the time would be readily available. (Tr. p. 121, ll. 17-23).

external benchmark. In other words, in the case of Tier 2, the "benchmark is the index, it is the market, and they're one in the same," according to Mr. Norwood. (Tr. p. 125, ll. 6-9).

165 Finally, Tier 3 daily purchases are made in order to balance the total supply for the day with the actual load. Under the Benchmark Mechanism, a symmetrical sharing incentive is applied to these daily Tier 3 transactions. Therefore, to the extent that the cost of these daily transactions differ from Tier 2 First of Month index costs, this difference, whether up or down, is shared 80% to customers and 20% to Avista Energy. Accordingly, these transactions are measured against an external benchmark (First of Month index costs), as part of the symmetrical sharing process (80%/20%). (Exh. 3T, p. 8, l. 17 – p. 9, l. 3). And again, the Daily Log, referred to above, provides an easy source of reference to these "benchmarks."

## VIII. THE MECHANISM COMPLIES WITH THE POLICY STATEMENT

166 Commission Staff, in particular, questions whether the Benchmark Mechanism comports with the Commission's Policy Statement, issued in Docket No. UG-940778, dated May 16, 1997. This Policy Statement purported to provide guiding principles for the development and implementation of purchased gas adjustment incentive mechanisms. At the outset, as Company Witness Norwood observed, the Commission acknowledged in the Policy Statement (item number 10) that:

167 > . . . the Commission should avoid establishing a one-size-fits-all incentive Mechanism. Each LDC should be allowed to file an incentive mechanism that conforms with these policies, and meets the Company's specific needs.

168 (Exh. 1T, p. 11, ll. 19-22). For reasons explained in Mr. Norwood's testimony, the Company believes that the proposed Mechanism does conform to the "spirit and intent" of the Commission's Policy Statement and satisfies its guiding principles, while still meeting the specific needs of the Company. (Id. at p. 12, ll. 1-3).

Moreover, in the Commission's own Policy Statement, it is noted as follows:

169 > This statement does not constitute a formal order binding upon either the Commission or the parties that may come before it in formal proceedings, nor is this Policy Statement a rule. It is neither feasible nor practicable to adopt a rule at this time, as these principles are not perfected so as to be binding on either the Commission or LDCs.

170 (See Exh. 3T, p. 14, l. 20 – p. 15, l. 5). Clearly, therefore, the Commission, when adopting the Statement, envisioned a flexible set of guiding principles that could be tailored to the specific needs of each company, and one that would promote – not inhibit – innovative thinking.[28]

171 Nonetheless, the Company's proposed Mechanism does satisfy the intent of the policy statement and its guiding principles. Exhibit 6 sets forth, in the form of a matrix, each guiding principle within the Policy Statement and describes how the Company's proposal addresses or, at a minimum, is not otherwise inconsistent with each such principle. (A copy of this Exhibit is also attached as Appendix I to this Brief.)

172 The following table, excerpted from Mr. Norwood's direct testimony, at page 14, summarizes the components of the Mechanism, including the incentives built into the Mechanism, auditability, and compliance with the Policy Statement.

[28] Mr. Norwood responded to Commissioner Oshie's questions concerning the need to embody the mechanism in a tariff, noting that the original proposal to put it in a tariff was "really driven by the policy statement and the effort that we have tried to make to honor that policy statement and be consistent with it, and so that's the first part. I don't

| Summary of Proposed Mechanism | | | |
|---|---|---|---|
| **Component** | **Incentive Built In** | **Auditable** | **Compliance with Policy Statement** |
| **Commodity**<br>**Tier 1** -<br>Fixed/Storage<br><br>**Tier 2** -<br>FOM to Average<br>**Tier 3** -<br>Daily Purchases and Sales | **YES:**<br>**80/20 Sharing for:**<br>-Basin Optimization<br>-Gains/losses on daily purchases and sales to balance load | **YES:**<br>Tier 1 and Tier 2 purchases will be tagged for the Utility. Tier 3 daily volumes will be Utility actual volumes, and will be priced at the average daily price of all AE's purchases for each day. | **YES:**<br>The Proposal includes sharing of gains and losses symmetrically within all components of the Mechanism. |
| **Storage** | **YES:**<br>**100% Cycle**<br>**80/20 Sharing of:**<br>-gains and losses from use of Storage to cover daily balancing<br>-Sharing of Inj/Withdr cycle. | **YES:**<br>All transactions will be Utility specific. | **YES:**<br>See above |
| **Transportation** | **YES:**<br>**Guaranteed $3m**<br>**80/20 Sharing for:**<br>-Capacity Releases and Off system Sales over guaranteed amount. | **YES:**<br>All transactions will be Utility specific. | **YES:**<br>See above |

## IX. THE MECHANISM FROM AVISTA ENERGY'S PERSPECTIVE

173 One of the advantages of the Mechanism, is that it parlays the strengths and market presence of Avista Energy into savings for customers, while preserving reliability of supply. Avista Energy's primary business focus with regard to natural gas is on the trading and marketing of natural gas in the Northwest. To that end, Mr. D'Arienzo explains the breadth of experience and scope of activity surrounding Avista Energy's gas trading function:

174 > As part of its business model, AE has assembled a team of experts, who have an excellent understanding of the physical flow of natural gas, as well as the financial markets and products that trade to meet the needs within the region. AE

know that it necessarily has to be in a tariff so long as we have a Commission order approving their proposal." (Tr. p. 247, ll. 15-25).

> is a major participant in all periods and types of products traded, in both electricity and natural gas, and as a result, has greater opportunities to achieve lower costs for Avista Utilities' customers. AE is integrally involved in the daily activities of all areas of the natural gas market, thus AE is able to provide the Utility with a high degree of reliability, reduced risk to counter-party default and management of currency risk. If the Utility were managing this load amount, their level of activity in the market would be significantly less. This lower level of activity makes it difficult to transact as timely or as effectively, especially when there are significant time constraints or deadlines.
>
> *175* In addition, since AE is a subsidiary of Avista Corporation, its interests are generally aligned with those of the Utility, since the Utility is the core of the corporation. Therefore, it is in AE's bests interests that Utility customers receive the best price and service possible.

(Exh. 101T, p. 3, ll. 1-16).

*176* The Benchmark Mechanism has effectively shifted many of the risks and costs associated with the Utility's gas procurement operations to Avista Energy. These costs and risks, as explained by Mr. D'Arienzo have increased significantly since 1999, when the Mechanism was first adopted. That is most apparent in the areas of price volatility, credit and counterparty risk. From Avista Energy's perspective, how is it to be compensated for assuming these additional risks? As revised, Avista Energy would receive a $900,000 per year management fee and, in addition, would have the opportunity to share in potential gains (and losses) through the symmetrical sharing incentives built into each component of the Mechanism. Mr. D'Arienzo, on behalf of Avista Energy, estimates that the management fee, together with the symmetrical sharing opportunities identified above, will provide Avista Energy with an average benefit, over time, of approximately $1 million per year. (Exh. 102C, p. 4, ll. 20-23). Exhibit 55-C shows what the results would have been had the proposed Mechanism been in place since 1999. It demonstrates that Avista Energy would have made, on average, less than $1 Million per year since 1999 ($987,315.65); and this figure <u>includes</u> Avista Energy's management fee of $900,000. (See Tr., p. 437, l. 16 - p. 438, l. 6.) This, should be compared with the estimated annual

customer benefits that total approximately $2.6 million, after taking into account the management fee paid to Avista Energy.

177 As shown in Bench Request No. 1, Avista Energy has actually lost money throughout the period the Mechanism has been in place. Bench Request No. 1 is an excerpt from the Company's response to Staff's Data Request No. 3, and includes estimates that show Avista Energy actually lost, on average, $1.1 million per year, under the Mechanisms that were actually in place since the inception of the original Mechanism in September 1999. (Tr. p. 193, l. 21 – p. 194, l. 10). According to Mr. D'Arienzo "this has not been – this has not been a good trade for Avista Energy." (Tr., p. 439, ll. 15-25.) On a going forward basis, however, Mr. D'Arienzo expects to achieve benefits of approximately $1.0 million per year.

## X. CONCLUSION

178 By way of summary, this Mechanism, first adopted in 1999, has been continuously refined and improved in the three different regulatory jurisdictions (Washington, Idaho and Oregon), and has been flexible to adapt to changed market conditions. It appropriately allocates risks and benefits between customers and Avista Energy. At the same time it utilizes the strengths and market presence of Avista Energy, in a way that provides real, tangible benefits to customers in the form of lower rates and the furnishing of reliable supply.

179 The Mechanism is also designed to be readily auditable and the components can be measured against external benchmarks. It is consistent with this Commission's prior Policy Statement on incentive mechanisms which, itself, is designed to encourage innovative approaches to gas procurement.

180 In the end, customers have and will continue to see net benefits as a result of this Mechanism. Were the gas procurement functions to revert to the utility, additional costs would

have to be absorbed by customers, with no opportunity to appropriately allocate risk between the Utility and Avista Energy. In the final analysis, there is no reason to abandon, at this time, a Mechanism that has served Avista's customers so well, especially in light of market conditions that are even more volatile than when the Mechanism was first adopted.

*181* Therefore, the Company respectfully requests that this Commission continue the Benchmark Mechanism through March of 2007, as requested, and in its preferred form. (See Tariff Schedule 163 in Exh. 153).

RESPECTFULLY SUBMITTED this ____ day of December 2003.

AVISTA CORPORATION

By: _____
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