[Service Date February 13, 2004]

BEFORE THE WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	)	DOCKET NO. UG-021584 SIXTH SUPPLEMENTAL ORDER REJECTING BENCHMARK MECHANISM TARIFF

***Synopsis**: The Commission rejects Avista's Natural Gas Benchmark Mechanism Tariff Schedule No. 163. The Commission extends the expiration of the current Benchmark Mechanism for 60 days. The Commission directs the parties to consult regarding transition, and directs Avista to present a plan within 30 days for transferring back to Avista Utilities the functions performed by Avista Energy under the current Mechanism. Chairwoman Marilyn Showalter dissents.*

I. INTRODUCTION

1 **Proceeding.** Docket No. UG-021584 involves a tariff revision filed by Avista Corporation d/b/a Avista Utilities (Avista) that would modify and extend Avista Tariff Schedule 163, Avista's "Natural Gas Benchmark Mechanism" (Benchmark Mechanism) for two years. The Benchmark Mechanism (current and proposed) establishes the natural gas costs for Purchased Gas Adjustment (PGA) deferral purposes.

2 **Appearances.** David Meyer, attorney, Spokane, Washington, represents Avista. Robert Cromwell, Assistant Attorney General, Seattle, Washington, represents Public Counsel. Donald T. Trotter, Assistant Attorney General, Olympia, Washington, represents the Commission.

3 **Commission.** Commissioners Richard Hemstad and Patrick Oshie reject the Benchmark Mechanism tariff because Avista failed to show that the affiliated interest transactions under the proposed Mechanism meet the statutory test of reasonableness. Chairwoman Marilyn Showalter dissents in a separate opinion below.

II. SUMMARY

4 The Commission's task in this docket is to determine whether it may properly approve a Benchmark Mechanism for natural gas costs proposed by Avista. The Mechanism is based in substantial part on an arrangement with an affiliated interest and is subject to our review under provisions of Chapter 80.16 RCW, which gives us the discretion to approve such transactions when we find them "reasonable." This order discusses the parties' presentations on the exercise of our discretion, the Commission's analysis of the facts and law pertinent to the decision, and the Commission's reasoning for its decision.

5 The Commission begins with a review of a frequent test of the reasonableness of an affiliated interest transaction, "lower of cost or market." [1] In the instant case,

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[1] *Utilities and Transportation Commission v. US WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supp. Order at 52-55, April 11, 1996; see also, Utilities & Transportation Commission v. Washington Natural Gas Co., Docket Nos. UG-911236/UG-911270, Third Supp. Order at 6, September 28, 1992; Western Distributing Co. v. Public Service Comm'n of Kansas, 285 U.S. 119, 52 S. Ct. 283, 76 L.Ed. 655 (1932).* Historically, the issue has most often arisen in the context of determining a company's rates in a general rate case, setting the level of allowable expense for an affiliated transaction already approved. Here, because the matter is proposed for inclusion in a tariff, we are not setting the level of allowable expense but, rather, are determining whether to approve the affiliated transaction for inclusion in a tariff.

Avista Energy provides both a service and a product to Avista Utilities. The record in this docket, however, contains no information about Avista Energy's cost to provide the service or, in critical respects, the product. Neither does the record reveal a market price for the services of Avista Energy. This test is therefore not available.

6 The Commission is unwilling to reject this proposal for failure to meet a single test, given the unique nature and the significance of the proposed arrangement.

7 The danger in an affiliated interest arrangement is that the pressure for profit creates a risk to ratepayers that management may shift the costs and burdens of company operations so that beneficial aspects flow to the affiliate (while benefiting the same stockholders) and burdensome aspects flow to the regulated company (and ultimately to ratepayers). In other words, any affiliated transaction poses a risk to ratepayers. Risks of manipulation, intentional or not, are inherent in any arrangement of this sort and are difficult to discover.

8 In order to approve this proposal, the Commission must find that safeguards exist to protect against bias in negotiations between Avista Energy and Avista Utilities, or that the transaction provides a significant, measurable benefit to ratepayers.

9 After reviewing the evidence, the Commission concludes that Avista has not shown the existence of adequate safeguards or the existence of a significant, measurable benefit to ratepayers. The Commission therefore rejects the proposal and directs the parties to consult on a transition plan to move Avista's Benchmark Mechanism operations out of Avista Energy and back to Avista Utilities.

III. PROCEDURAL HISTORY AND BACKGROUND

10 Avista Energy currently procures natural gas for Avista Utilities under the Natural Gas Benchmark Mechanism (Benchmark Mechanism or Mechanism) included in its Tariff Schedule 163.[2] The Benchmark Mechanism is intended to give Avista Energy an incentive to procure reliable, least-cost gas for Avista Utilities' customers. Avista Utilities and Avista Energy have common ownership.[3] Both are the ultimate responsibility of Mr. Gary Ely, the Chief Executive Officer of Avista. There is no dispute among the parties that Avista Utilities and Avista Energy are affiliates or that the proposed Benchmark Mechanism constitutes an affiliated transaction.

11 Avista filed the tariff revision on December 2, 2002, to take effect on April 1, 2003. On January 29, 2003, the Commission suspended Avista's proposed Benchmark Mechanism tariff, extended the existing Tariff No. 163 until January 29, 2004, and set the matter for hearing. On January 27, 2004, Avista waived the expiration of the suspension period for two weeks, until February 14, 2004, and the Commission, on January 28, 2004, further extended Tariff Schedule No. 163 until February 14, 2004.

12 Avista, Commission Staff, and Public Counsel filed testimony and exhibits according to an agreed filing schedule. At the time of a prehearing conference on September 19, 2003, the parties engaged in settlement discussions, assisted by Administrative Law Division Director C. Robert Wallis. The parties reached

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[2] *Exhibit 204.* The agency agreement governs the relationship between Avista Utilities and Avista Energy and assigns to Avista Energy the right to manage all of Avista Utilities' supply, transportation, and storage contracts.

[3] *Exhibit 201T at 16.* Avista Energy is a wholly owned subsidiary of Avista Capital, Inc. Avista Capital Inc. is a wholly owned subsidiary of Avista Corporation. Avista Corporation operates the regulated utility business under the name Avista Utilities. In this Order, we refer to "Avista" as the Corporation as a whole, *e.g.*, it is "Avista" that filed this petition. "Avista Energy" refers to the affiliate that operates the Benchmark Mechanism currently and as proposed. "Avista Utilities" refers to the regulated utility.

agreement in principle on September 22, 2003, and presented the settlement agreement to the Commission on September 23, 2003.[4] On October 6, 2003, the Commission entered its Fourth Supplemental Order Approving In Part and Rejecting in Part, the settlement agreement.

13 Based on the partial rejection decided in that order, Commission Staff and Public Counsel withdrew from the settlement agreement. The Commission convened an evidentiary hearing on December 15 and 16, 2003, before Chairwoman Marilyn Showalter, Commissioners Richard Hemstad and Patrick Oshie, and Administrative Law Judge Theodora Mace.

14 **Description of the Proposed Benchmark Mechanism.** The proposed tariff schedule establishes a Benchmark Mechanism[5] that vests Avista Energy with the task of procuring gas for its affiliate Avista Utilities.[6] It includes a strategy for gas procurement[7] and incentives for Avista Energy intended to maximize the revenue opportunities and minimize the cost of using Avista Utilities' assets.[8] Avista Utilities' total cost of gas in the state of Washington for the period April 1,

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[4] During the hearing on September 23, 2003, all exhibits were admitted, except Exhibits 22, 23 and 24 (Avista's Integrated Resource Plans) and responses to Bench Request Nos. 1 and 2. Exhibits 22-24 were admitted on November 24, 2003. The responses to Bench Requests are admitted at this time.

[5] Avista's current Benchmark Mechanism is contained in Tariff Schedule 163, filed with the Commission. Avista proposes that its preferred substitute mechanism, contained in Exhibit 153, be approved by the Commission for a period extending until March 31, 2007. The preferred mechanism constitutes a revision of the tariff the company filed with its petition on November 29, 2002. The earlier version of the tariff is found in Exhibit 152. A version of the Benchmark Mechanism also currently operates in Idaho and Oregon. The expiration date for the Mechanism in those two states is March, 2005. *Exhibit 1T at 7*.

[6] *See fn. 3 supra*.

[7] The gas procurement strategy involves buying and selling gas, managing transportation, and managing storage.

[8] The Strategic Oversight Group (SOG) supervises the operation of the Benchmark Mechanism. The SOG consists of a team of employees from both Avista Utilities and Avista Energy. The ultimate decision maker on the SOG is Mr. Robert H. Gruber, Avista Utilities' Manager of Natural Gas Resources. *See Exhibit 3T at 9; T 426; Exhibit 51T at 11-12*.

2002, through March 31, 2003, was approximately $76 million.[9] Of that amount, approximately 76% were commodity costs, 6% were storage costs, and 18% were transportation costs. There are four components to the mechanism: commodity, basin optimization, storage, and capacity release/off-system sales. In addition, Avista Utilities pays Avista Energy a management fee and incentives.

15 **Commodity component.** This component contains three tiers. Tier 1 and Tier 2 each account for 50% of Avista Utilities' projected daily load, for a total of 100%. For these two tiers, the estimated load is based on the average of the company's last five years' actual loads.[10] For Tier 1, Avista Energy secures gas for Avista Utilities through the use of long-term contracts and storage. For Tier 2, gas is secured through monthly contracts purchased at First of the Month (FOM) Index pricing.[11] Tier 1 and 2 purchases are not part of the incentive mechanism.[12]

16 Tier 3 gas is used to balance the company's load on a daily basis, and accounts for approximately plus-or-minus 8% of Avista Utilities' total gas load. If the company's actual load on a particular day is above or below the projected daily load, Avista Energy will buy or sell gas, withdraw gas from or inject gas into storage, or supply any daily load imbalance from its portfolio.[13] Gas purchased or sold for Tier 3 load balancing is priced at either Avista Energy's average daily purchase or sale price, or at the Gas Daily Index (GDI) if Avista Energy does not need to buy or sell gas on a given day.

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[9] *Exhibit 2.*
[10] *T 218.*
[11] *T 119.*
[12] *T 128.*
[13] *Exhibit 51T at 12, 13, 16;* The decision to purchase/sell gas through the daily market or to use storage gas is based on the average daily price and the estimated cost to replace storage in the future.

17 All Tier 3 transactions are included in the incentive mechanism, which uses the FOM index as its benchmark.[14] The average daily price paid by Avista Energy for gas purchased for Avista Utilities is compared with the FOM index. If Avista Energy's cost differs from the FOM index, Avista Energy retains or pays 20% of the difference while the remaining 80% goes to, or is paid by, Avista Utilities.[15]

18 **Basin Optimization Component.** Related to the commodity component is the Basin Optimization part of the Mechanism. Avista buys gas from three different sources or basins. Two are Canadian: Alberta (AECO) and British Columbia (Sumas). The third is a U.S. source: the Rockies.[16] Under the proposed Mechanism, Avista Energy establishes "basin weightings" by the first of February, which become effective in November of each year. The basin weightings determine the principal amount of gas to be purchased from each basin and reflect the amount of transportation available to carry that gas to Avista Utilities' customers.[17] Gas purchased for Tier 1, Tier 2, and storage is priced to Avista Utilities based on the basin weightings. However, Avista Energy may actually purchase Tier 1 and Tier 2 gas for Avista Utilities at the cheapest of the basins, depending on available transportation. Under the proposed Mechanism, Avista Energy retains 20% of any benefit from such transactions.[18]

19 **Storage Component.** Avista owns part of the Jackson Prairie gas storage facility in Washington. Under the proposed Mechanism, gas in storage is priced

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[14] *T 127.*
[15] *Exhibit 51T at 19*.
[16] *Exhibit 201T at 6-7; Exhibit 202*.
[17] *T 145-148*; *Exhibit 152, Tariff Definitions, No. 1.* The FOM Weighted Average Index Price is the weighted average of the published index prices for the three supply basins. The price at each basin is the actual "first of the month" price as reported in two gas price reports for the applicable basins. The published index prices are weighted (as determined in February each year, with a November effective date): 50% AECO; 18% Sumas; and 18% Rockies. The remaining 14% is assigned among the three basins by Avista Energy by January 1st of each year.

according to a synthetic schedule.[19] This primarily involves the injection of less expensive gas into storage in summer and the withdrawal of that gas during the winter when gas supplies are typically more expensive.[20] The synthetic schedule is intended to achieve a total injection/withdrawal cycle while protecting storage gas pressure and availability.[21]

20 Under the proposed Mechanism, if the weighted average cost of storage gas at the end of the injection season is above or below the aggregate benchmark weighted average cost of gas set by the synthetic injection schedule at FOM, Avista Utilities' customers will share the costs or benefits with Avista Energy on the basis of 80% (customers),[22] 20% (Avista Energy).[23] As stated above, storage gas can also be used to serve Tier 3 gas needs, consistent with the injection schedule and the ability of the storage facility to provide peaking gas. Avista Utilities and Avista Energy share, on an 80/20 basis, the difference between FOM and gas index prices for Tier 3 gas withdrawn from or injected into storage.[24]

21 **Transportation Component**. This component involves capacity release and off-system sales transactions. Capacity release is the release of Avista Utilities' reserved transportation capacity to a third party to allow that party to ship gas. Off-system sales involve the actual sale of gas to off-system buyers. Avista Energy manages Avista Utilities' transportation assets, including its pipeline capacity. Avista Utilities is charged for all reserved transportation capacity whether it is used to deliver Avista Utilities' gas supply or not. However, Avista

[18] Under the current form of the Mechanism, Avista Energy retains 100% of the benefits from basin optimization.
[19] *Exhibit 201T at 11*.
[20] *T 140-141*.
[21] *Exhibit 51T at 18-19*.
[22] Avista Utilities is the regulated entity within the Avista corporate structure. In the calculation of Avista Utilities' rates, ratepayers are the beneficiaries of reductions in expense and the bearers of the burden of additional costs. For that reason, in most instances when we refer to the benefit or cost to Avista Utilities or its ratepayers, both are similarly affected.
[23] *Exhibit 51T at 19*. In the remainder of this order, we may refer to this as 80/20 sharing.

Utilities is credited with any benefits Avista Energy achieves through capacity release and off-system sales transactions. The benefits are calculated based on the price differential between the market price at the delivery point and the market price at the receipt point. Under the proposed mechanism, Avista Energy would guarantee a minimum of $3 million[25] to Avista Utilities' ratepayers from capacity release and off system sales transactions. Any amount above that is subject to 80/20 sharing.

22 **Management Fee.** Finally, under the proposed Mechanism, Avista Utilities will pay Avista Energy a $900,000 management fee, in addition to any benefits Avista Energy derives from 80/20 sharing. The management fee replaces the 5 cents per dekatherm surcharge in the current Mechanism.[26]

IV. AFFILIATED INTEREST TRANSACTIONS

23 In this case, the Commission must review an affiliated interest transaction that consists of a natural gas procurement service and an incentive mechanism related to gas procurement. The Commission reviews affiliated transactions pursuant to the affiliated interest statutes set out in Chapter 80.16 RCW.

24 The purpose of the affiliated interest statute is to protect ratepayers from cross-subsidization by regulated companies of unregulated affiliates. Because a regulated utility and an affiliate do not engage in arms' length bargaining with each other, the regulated utility has the burden to demonstrate that its transactions with an affiliate are reasonable.

[24] *Id.*
[25] *See Avista initial brief at ¶143.* Avista witness D'Arienzo indicates Avista Energy might be able to increase this guaranteed amount to $4 million.
[26] *Exhibit 1T at 9.*

25 Commission Staff and Public Counsel contend that several flaws are inherent in Avista's proposal, and consequently they assert that Avista has not met its burden of proof under RCW 80.16.020 to demonstrate that the affiliated interest arrangement is reasonable. They contend: 1) the proposed Mechanism does not meet the "lower of cost or market" standard for affiliate transactions; 2) the Mechanism is poorly and improperly structured; and 3) ratepayers will receive greater benefits if the Mechanism functions revert back to Avista Utilities.

A. "Lower of Cost or Market" Standard.

26 Commission Staff[27] argues that the Benchmark Mechanism is an affiliated transaction whose reasonableness can only be determined by applying a "lower of cost or market" standard.[28] Staff argues that Chapter 80.16 RCW[29] was enacted to protect against improper cross-subsidization of a non-regulated company by an affiliated regulated utility.[30] As noted above, there is no dispute among the parties that Avista Utilities and Avista Energy are affiliates or that the Benchmark Mechanism constitutes an affiliated transaction. Staff contends that Avista cannot prove either the actual market value of the services Avista Utilities receives from Avista Energy or Avista Energy's actual cost of supplying Avista

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[27] Public Counsel generally agrees with Staff's arguments in opposing the proposed Benchmark.
[28] *Utilities and Transportation Commission v. US WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supp. Order at 54, April 11, 1996; see also fn. 1,supra.*
[29] Chapter 80.16 RCW addresses the Commission's role in regulating transactions between regulated public utility companies and their unregulated affiliates. RCW 80.16.020 states that the Commission "may" disapprove any affiliated arrangement if "satisfactory proof is not submitted…of the cost to the affiliated interest of rendering the services or of furnishing the property or service." RCW 80.16.030 allows the Commission to disallow a payment to an affiliate "in the absence of satisfactory proof that it is reasonable in amount." RCW 80.16.040 states that no proof of reasonableness is satisfactory unless it includes original evidence of costs, although it allows the Commission to consider evidence of reasonableness absent cost information.
[30] *Staff initial brief at 11; see also Western Distributing Co. v. Public Service Comm'n of Kansas, 285 U.S. 119, 52 S.Ct. 283, 76 L.Ed.655 (1932).*

Utilities with gas.[31] Staff asserts that for this reason, Staff cannot properly audit the performance of the Mechanism.

27 Staff bases its contentions on several factors: 1) the Agency Agreement governing the relationship between the affiliates was not competitively bid; 2) Avista Energy does not track its actual revenues and costs on a per-therm basis; 3) Avista Energy manages Avista Utilities' gas load as part of Avista Energy's total gas portfolio (all of Avista Energy's activities influence the average actual cost it incurs to provide gas to Avista Utilities); 4) there is not a single component of the Benchmark Mechanism that measures Avista Energy's cost; and 5) nowhere is Avista Energy's actual cost documented.

28 With regard to Tier 1 and Tier 2, Staff contends the Mechanism does not price gas at Avista Energy's cost. Rather, in Tiers 1 and 2 the price of gas to Avista Utilities is imputed, based on contracts for purchase of gas entered into by Avista Energy.[32] Avista Utilities' Tier 1 and Tier 2 gas loads form a portion of Avista Energy's total load responsibilities. Avista Energy's day-to-day portfolio transactions affect its actual cost of gas to serve Avista Utilities' loads, irrespective of the imputed price based on the long-term contracts associated with gas load for those tiers.[33] With regard to the basin optimization component, gas volumes are priced based on basin weightings, not based on Avista Energy's actual costs. With regard to the transportation component, Staff states that Avista Utilities reports neither the actual revenue Avista Energy receives, nor Avista Energy's actual cost of gas being sold off-system.[34] Finally, with regard to the storage component, the gas Avista Energy procures for storage is priced at First of the Month (FOM) index prices, not at the price Avista Energy actually pays for the gas.[35]

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[31] *Staff initial brief at 1*.
[32] *Exhibit 51T at 11-13; see also Staff initial brief at 14.*
[33] *Exhibit 201T at 24-27.*
[34] *Exhibit 201 at 27-28, T 369-373.*
[35] *T 142-143*. The price of gas at withdrawal is based on the average inventory price at that point.

29 Avista argues that there is an auditable external benchmark for every component of the Benchmark Mechanism. For Tier 1, the market price at the time of execution of a fixed price contract is the benchmark; for Tier 2 and Tier 3 the FOM Index is the benchmark. Avista asserts that both Tier 1 and Tier 2 commodity transactions are "tagged" as being for Avista Utilities. Moreover, Avista Energy proposes to provide a daily log that would record all commodity transactions on a daily basis. The daily log would supplement the quarterly reports[36] already provided to the Commission. Avista Energy also assures the Commission that all its transactions under the Mechanism would be open to Commission Staff for review.[37]

30 Staff argues that FOM or GDI index prices do not provide the Commission with information about Avista Energy's actual costs, nor do the index prices show whether improper cross-subsidization is taking place under the Mechanism. Staff states that quarterly reports and the proposed daily log only provide information about Avista Energy's billing under the Mechanism's pricing formula. Using them, Staff might be able to verify the calculations, but still would not be able to audit the Mechanism to determine whether the "lower of cost or market" standard is being met, or to determine Avista Energy's actual costs.

31 Staff uses, as an example of the inadequacies of the Mechanism to demonstrate actual cost, Avista Energy's "flexibility" to "rearrange the portfolio" on a daily basis to take advantage of basin optimization opportunities.[38] Staff claims that Avista Energy can rearrange its portfolio by selling Tier 1 or Tier 2 gas at the

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[36] Avista currently submits quarterly reports to the Commission on the operation of the Mechanism. These reports indicate the gas costs resulting from the Mechanism that are accounted for and passed through to ratepayers in the Purchased Gas Accounting Mechanism. *See Exhibit 151T at 3*.

[37] *Exhibit 101T at 6*.

[38] *Staff reply brief at 4; Avista initial brief at 23-24.*

point of purchase, or to another Avista Energy customer. As long as Avista Energy does not use Avista Utilities' pipeline capacity to deliver the gas, the Mechanism provides no benefit to Avista Utilities or its customers from these sales.[39] Such transactions may affect Avista Energy's gas costs but gas prices paid by Avista Utilities do not change. The quarterly reports and the daily log will not report the effect of all these transactions. This rearranging of Avista Energy's portfolio has a direct bearing on its actual cost to serve Avista Utilities, but that cost cannot be tracked or audited.

32 **Decision.** Under RCW 80.16.030, the Commission must review affiliated transactions to determine whether they are "reasonable," and the regulated company is directed to provide evidence of cost. In the past the Commission has found that the price of goods or services acquired through an affiliated transaction should be determined based on a "lower of cost or market" standard, in order to safeguard against the lack of arms' length bargaining. The Commission has set the cost of the affiliate's product or service for ratemaking purposes to the lower of the actual cost to the affiliate or the price at which the product or service is available from a willing third-party supplier in the market for such goods or services.

33 In this case, the affiliated transaction involves both a service and a product. The service is managing the procurement of natural gas. The product is the gas itself. The two must be reviewed separately. Our review reflects the concern that Avista Utilities and Avista Energy share the same management and the affiliated transaction, as contained in the proposed Benchmark Mechanism, results from inherently conflicted negotiations between the two affiliates.[40]

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[39] *Staff reply brief at 4; T 140.*

[40] Avista could have approached the lower of cost or market standard, and thus addressed the question of bias in affiliate negotiations, by letting the proposed Mechanism out for competitive bid. Avista did issue a Request for Proposals (RFP) to solicit bids related to procurement of gas in Tier 2. However, this RFP process did not cover all segments of the proposed Benchmark Mechanism. While concerns related to auditing the performance of an independent third party

34 With reference to the service of portfolio management, Avista provided no information about the affiliate's costs of providing the service – the cost of employees' and executives' time, the cost of telephones and rent and computers and paper and all of the other parts of running a business. Neither did Avista provide information of the costs at market of competing suppliers to provide the service. It did not conduct a request for proposals from which it could judge whether Avista Energy's costs are reasonable, did not provide price lists from other suppliers, and did not provide evidence of Avista Energy's charges to its similarly situated third-party (nonaffiliated) clients.[41]

35 Furthermore, there is no indication on the record of what actual costs to Avista Energy the $900,000 management fee is designed to cover. All the record shows is that the fee is intended to "cover a portion of the risks and costs being borne by Avista Energy."[42] The actual extent to which Avista Energy's risks and costs are compensated by the management fee remains speculative. This problem is compounded by the fact that the Mechanism's incentive payments provide additional compensation to Avista Energy for the services rendered.[43]

36 The record indicates a mixed purpose for the incentive payments made to Avista Energy. Like the management fee, the incentive payments would partly compensate Avista Energy for the risks borne and costs incurred in providing the

would require attention, at least the bid process would have given the Commission a better idea of the market price for the services Avista Energy performs under the Mechanism to earn the $900,000 management fee that it receives from Avista Utilities.

[41] The record shows that Avista Energy provides gas procurement to the city of Ellensburg. Information about fees is lacking and the two entities are dissimilar—the city makes up less than one percent of Avista Energy's gas sales, for example, and does not make comparable transportation and storage assets available to Avista Energy.

[42] *Exhibit 1T at 9; but see also, Exhibit 251C at 16.*

[43] The fee and incentive payments are not the only advantages that Avista Utilities provides to Avista Energy. The latter exercises control over assets of the former for transportation and storage of natural gas, but the record contains no quantification of the value of those rights.

service. In addition, some portion of these payments would supplement Avista Energy's overall compensation to incent the most efficient behavior. We cannot determine from the record what portion of the incentive payment is an adder to the management fee and what portion is simply an incentive.[44]

37 Although the Commission does not, in this instance, require a perfect accounting of every dollar allocated to each specific service, the evidence must show some symmetry between the compensation paid to Avista Energy and the services rendered to Avista Utilities. We fully understand that this transaction reflects in part the dynamic and fluid environment of the natural gas market. We also understand the difficulty of assigning a dollar value for protection from certain market risks. However, even after considering these uncertainties, we find the record lacks the evidence required for us to ascertain with any precision what portion of the compensation Avista Energy receives from Avista Utilities is paid for services performed and what portion of the compensation is awarded to Avista Energy solely as an incentive for efficient performance.

38 In short, we do not know Avista Energy's actual costs to provide the service, we do not know whether its costs reflect the "market" price, we do not know what services are covered by the management fee, and we do not know how the price paid by Avista Utilities is apportioned between Avista Energy's compensation for services and the incentives paid for efficiency.

39 Nor is the record much better when we attempt to determine the cost or market figures for the product that Avista Utilities buys, the natural gas it delivers to its consumers.

[44] Furthermore, the record does not adequately support a finding that the 80/20 split, to incent more efficient behavior, is reasonable under the circumstances. We only know that this is the split Avista Utilities and Avista Energy agreed upon. We do not know if Avista Utilities could get a better deal if the incentive arrangement were put out to bid.

40 While the sale price of Tier 3 gas supplied by Avista Energy to Avista Utilities is based on the market, assuring that Avista Utilities' costs for that gas would generally follow the market, Avista provided insufficient information as to Avista Energy's cost for that Tier 3 gas supply. Avista Energy may meet Tier 3 needs from its own resources at different costs, but the record contains no information about Avista Energy's actual or the average cost of Tier 3 gas supplied to Avista Utilities.

41 Consequently, we conclude that there is insufficient evidence of record to allow application of the "lower of cost or market" test to determine whether the Benchmark Mechanism has adequate safeguards to meet the statutory standard.

B. Alternative Measures of Reasonableness

42 Avista argues that neither the affiliated interest statutes nor the Commission[45] prohibit affiliated transactions such as those included in the Benchmark Mechanism. Avista contends that, rather than focusing on the "lower of cost or market" test to provide safeguards for Avista Utilities' ratepayers against lack of arms' length bargaining, the Commission therefore has the discretion to evaluate the Mechanism by looking at the "bigger" question: will ratepayers benefit?[46]

43 Avista asserts that ratepayers will benefit from Avista Energy's market presence and specific skills; from Avista Energy's absorption of counterparty, credit and other risks; and from the alignment of Avista Energy's interests with Avista Utilities to maximize the benefits that would accrue both to itself and the ratepayers under the Mechanism. In addition, Avista points out that if Avista Utilities were to perform the procurement function instead of Avista Energy,

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[45] *Policy Statement on Purchased Gas Incentive Mechanisms, Docket No. UG-940778 and UG-970001, May 29, 1997.*
[46] *Avista reply brief at 1-2.*

Staff's ability to audit would not improve because the benchmarks would still be market prices.

44 Avista also points out that the issue of using "lower of cost or market" as a guide would not arise if the Benchmark Mechanism were operated by an independent third party. The Commission would still not know what the actual costs of the third party were. Avista concludes that the basis for judging the reasonableness of the Mechanism should be whether the Mechanism is a "good deal" for ratepayers.

45 As noted above, Commission Staff recommends that we reject the Mechanism for failure of the Company to provide the cost or market information necessary to evaluate it, as required by RCW 80.16.040.

46 **Decision.** We are persuaded that under RCW 80.16.040 we have the discretion to look at other measures, beyond the "lower of cost or market" test, in order to determine the reasonableness of the Benchmark Mechanism. Given the significance of the Mechanism, the claimed advantages and synergies of the affiliated relationship between Avista Energy and Avista Utilities, the integrity of Avista's management, and the consequences of rejection, we will examine whether Avista Utilities has shown that there are significant, measurable benefits to ratepayers sufficient to offset the uncertainties and lack of safeguards inherent in the affiliated transactions. Such benefits may be found in the structure of the Mechanism, and in the analysis of quantifiable costs and benefits to Avista Utilities if it were to perform the Mechanism's functions.

1. Structure of the Proposed Mechanism; Allocation of Risks.

47 The issue here is whether the structure of the proposed Mechanism provides an allocation of risks that is not biased in favor of the affiliate. Staff and Public Counsel argue that the proposed Mechanism is structured so that there is little

actual risk to Avista Energy and little place for the exercise of Avista Energy's market expertise. Staff and Public Counsel agree with Avista that "a benchmark should measure cost deviations resulting from decisions and actions over which the company has some control. The Utility should be rewarded or penalized on its decisions, not simply because the market trends up or down."[47]

48 Staff and Public Counsel argue that the proposed Benchmark Mechanism does not meet this guideline. They observe that although there are indices that govern the price of gas for Tiers 1 and 2, the Benchmark Mechanism contains no benchmark price or cost that Avista Energy can either beat or fail to meet.[48] Therefore the bulk of gas procured by Avista Energy for Avista Utilities is not subject to any incentives. With regard to Tier 3, Staff and Public Counsel point out that Avista Energy admits its performance in making these daily purchases under the current Mechanism has been the same as if it had simply bought or sold gas at the GDI.[49] Moreover Staff argues that the Mechanism is poorly designed because it would reward Avista Energy whenever it purchases Tier 3 gas at a price below the FOM index, even if that price is above the Gas Daily Index.[50]

49 With regard to the storage component, the synthetic schedule requires injections into storage in summer when gas prices are typically lower, and withdrawals in winter when prices are typically higher. Staff and Public Counsel assert that Avista Energy has no control over this winter-summer price differential, but

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[47] *Staff initial brief at 17 quoting from Exhibit 22 at C-10 (Avista 1997 Integrated Resource Plan or "IRP"); Exhibit 23 at C-4 (Avista 2000 IRP); Exhibit 251T at 5*. The context of Staff's quotation from Exhibit 22 is the typical circumstance where a benchmark is used to measure a *utility's* performance. Here the benchmark would be used to measure the performance of an *affiliate* of the utility.
[48] *T 120-126; see also Public Counsel initial brief* at 2.
[49] *Exhibit 3T at 12; T 128.*
[50] *T 265*. The Gas Daily Index averages all transactions of all market participants for a given day.

nevertheless the Mechanism provides a reward whenever summer prices are lower than winter prices.[51]

50 With respect to the transportation component of the proposed Mechanism, Staff and Public Counsel claim that Avista Energy can be rewarded for average, or even below-average performance. They contend that the $3 million guarantee Avista proposes to give ratepayers (with 80/20 sharing for amounts above that level) is not sufficient, in view of Avista's track record in obtaining these revenues. They point out that capacity release revenues alone have exceeded the $3 million level every year since 1996.[52] They also point out that most of the capacity release transactions that generate these revenues are the result of long-term contracts entered into by Avista Utilities before the Mechanism went into effect,[53] and that it is not appropriate for Avista Energy to benefit from them.

51 Staff and Public Counsel argue that there is no risk to Avista Energy with regard to operation of the basin optimization component of the proposed Mechanism, yet Avista Energy would reap rewards. They point out that basin weightings are set once per year. This determines the price Avista Utilities will be charged for Tier 1, Tier 2, and storage gas from the basins,[54] and also the amount of transportation capacity available to Avista Energy from each basin for transport of that gas.[55] However, since Avista Energy can actually purchase gas on a daily basis from the cheapest basin, depending on available transportation, Avista Energy can only gain benefits under the Mechanism. They argue that since

[51] *T143-144*. Staff and Public Counsel also acknowledge that because the Benchmark simply rewards or penalizes based on market trends, Avista Energy can also be penalized for its performance when winter prices for storage gas are lower than in summer months, which occurred in 2003. In this instance, a market-driven change required Avista Energy to absorb a portion of the difference between the average storage inventory price and the FOM Index price at time of withdrawal of storage gas.
[52] *Bench Request #2; Exhibit 212; Staff initial brief at 22.*
[53] *T 539; Exhibit 257C at 2.*
[54] *See fn. 13.*

Avista Energy enters into basin optimization transactions only when there is a benefit, the risk is asymmetrical and it is inappropriate to allow Avista Energy to gain from the situation. Moreover, they contend that Avista Utilities was adept at capturing this value well before any Benchmark Mechanism was put in place.[56]

52 Public Counsel points out that if Avista Utilities were performing the gas procurement function, it would face the same market conditions and would purchase gas in the same way as proposed under the Benchmark Mechanism, in most cases, in an equally effective fashion.[57] In fact, through the actions of the Strategic Operations Group that oversees the workings of the Mechanism, Public Counsel argues that Avista Utilities, through Mr. Gruber, is actually making decisions for which Avista Energy reaps a reward. Public Counsel asserts that Mr. Gruber, or any prudent gas purchasing agent, could achieve most, if not all of the same benefits that Avista Energy would gain under the proposed Mechanism.[58]

53 Staff also contends that the affiliated nature of the Mechanism may create unforeseen opportunities for Avista to bias rewards toward Avista Energy. Staff points out that under the current Mechanism, there is no sharing of basin optimization benefits. In 2002 Avista Energy received over $6.2 million in such benefits. At the same time, Avista Energy gained only $1.6 million in off-system sales. Staff argues that Avista Utilities did nothing to stop Avista Energy from foregoing off-system sales, the benefits from which would have had to be shared with ratepayers, and maximizing its own benefits from basin optimization for which sharing was not required.[59]

[55] The weightings also determine how much transportation capacity may be available for capacity release or off-system sales.
[56] *T 160; 162*.
[57] *Public Counsel initial brief at 5-7*.
[58] *T 245; 273-274; 352; see also Public Counsel initial brief at 8*.
[59] *Staff reply brief at 26-27*.

54 Staff also points out that Avista Energy projects that it will net only $100,000 in annual benefits from the Mechanism.[60] Staff contends this is not a "meaningful" incentive. Staff states that either the proposed incentives are insufficient, or, more likely, Avista has grossly understated the benefits expected.[61]

55 Avista responds that the Commission should view the Mechanism as a whole, rather than focusing on one part of it or another. Avista argues that with regard to the basin optimization revenues it received, the Commission should balance those revenues with its $8.8 million loss in 2000[62] covering Avista Utilities' load volatility risk. The proper question, according to Avista Energy, is whether Avista Utilities could do as well in performing the gas procurement function.

56 In any event, with regard to Tier 3, Avista argues that even if Avista Energy only does an average job, the amount of gas involved is small, only 8% of Avista Utilities' load on an annual basis. With regard to storage, Avista Energy would recycle 100%, a benefit Avista Utilities would not usually be able to take advantage of. Avista Energy also would have greater access to storage and transportation market opportunities than Avista Utilities. Consistent with the testimony of Mr. D'Arienzo, Avista indicates in its post-hearing brief that Avista Energy would be able to increase the guaranteed benefit from the transportation component of the proposed Mechanism to $4 million, rather than $3 million.[63] In addition, Avista points out that Avista Energy would bear other risks, including counterparty, credit, and delivery risks that would otherwise be borne by Avista Utilities. Thus, Avista argues that the proposed Benchmark Mechanism is properly structured and would provide benefits to ratepayers that Avista Utilities could not.

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[60] *Staff reply brief at 6*. Avista Energy expects a net benefit of $1 million, which includes $100,000 in incentive payments and the proposed $900,000 management fee.
[61] *Staff reply brief at 6.*
[62] *T 196-197.*
[63] *Avista initial brief at ¶143; see also, Exhibit 201T at 50.* Staff testifies that a guaranteed benefit would have to be $7 million to adequately compensate Avista Utilities.

57 **Decision**. It is clear that Avista Energy bears little risk and stands to obtain significant benefits from the basin optimization and capacity release segments of the Mechanism. In those segments, Avista Energy merely takes advantage of market trends over which it has no control.[64] Given the asymmetrical risks associated with these segments discussed above, the benefits to Avista Energy outweigh the risks.

58 In addition, Avista Energy would receive a $900,000 management fee that covers unspecified costs, further cushioning any risk to it under the proposal. Added to this is the fact that under the current mechanism, Avista Energy has done no better than the market in meeting Avista Utilities' load balancing needs. There is no reason to presume that it could do better under the similar proposed mechanism.

59 Avista's contention that 80/20 sharing applies to every segment of the proposal does not mitigate the minimal risk to Avista Energy. Rather, it highlights the fact that Avista Utilities gains little, and loses opportunities for gain, through its arrangement with Avista Energy for gas procurement operations, especially since Avista Utilities' management is already making the ultimate decisions under the current Mechanism and has proven that it can be successful in conducting those operations.

60 Even though load volatility management may represent some risk to Avista Energy, Avista did not demonstrate that the proposed Mechanism, as a whole, is structured to reward or penalize Avista Energy based on its expertise and ability to maximize benefits and avoid risks due to market trends. Instead it appears

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[64] *Avista responses to Bench Request Nos. 1 and 2; see also Staff initial brief at 23.* In 2002, Avista Energy received approximately $8 million in revenues from basin optimization and capacity release transactions. Under the proposed Mechanism, Avista Utilities and Avista Energy would

that Avista Utilities could just as easily take advantage of and accept the risks of such market movements at less cost to ratepayers.

2. Quantifiable Costs and Benefits.

61 Avista asserts that customers would benefit from the Mechanism because of Avista Energy's greater presence in the market for commodity, transportation, and storage services.[65] Commission Staff, on the other hand, asserts that it is Avista Energy that benefits from the Mechanism, through its access to Avista Utilities' assets, including transportation capacity, which provide economies of scale and market presence to Avista Energy, the benefits of which have not been captured in Avista's analysis.[66]

62 Avista provided its own detailed analysis of the benefits Avista Utilities' customers would forego if the Benchmark Mechanism were ended and the gas management function was transferred back to Avista Utilities. It first quantified these at approximately $2.6 million annually but revised the estimate downward to $1.1 million in its reply brief.[67] Staff countered the estimate with its own analysis, which showed a $1.6 million benefit to customers should the Benchmark Mechanism's functions revert to Avista Utilities.[68] A side-by-side comparison of these two analyses is shown in Table 1, which has been taken from Exhibits 51T and 208 and modified to include Avista's revised estimate of load volatility costs.[69]

share capacity release and off system sales revenues, above the $3 million guarantee to Avista Utilities, on an 80/20 basis and basin optimization revenues on an 80/20 basis.

[65] *Exhibit 52 includes a catalog of benefits provided to Avista Utilities' customers*.

[66] *Exhibit 201T at 52; Exhibit 117; see also Staff initial brief at 36.* Avista Utilities' transmission assets provide 58 percent of Avista Energy's total transmission capacity. Avista Energy also utilizes Avista Utilities' storage capacity to manage Avista Energy's total portfolio.

[67] *Exhibit 3T at 3, Avista reply brief at 15.*

[68] *Exhibit 208.*

[69] This valuation was determined by subtracting $1,538,422 from Avista's original estimate of $231,000. *Avista Reply Brief at 15.* The difference between Avista's and Staff's numbers represents

Table 1 **Estimated Annual Incremental Costs Associated with** **Natural Gas Procurement Managed by Avista Utilities vs. Avista Energy**		
Avista Utilities Managing Gas Procurement **(Benefit) or Cost**		
Expense Category	**Avista (RHG-1T)**	**Staff Exhibit (MPP-8)**
Employee (loaded labor plus support costs)	**$408, 500**	**$408,500**
Credit	**$512,500**	**$512,500**
Premium for Physical Delivery	**$123,200**	**$123,300**
Currency	**$176,000**	**$0**
Load Volatility	**($1,307,422)**[70]	**($1,759,855)**
Estimated Loss of Transportation Benefits	**$2,000,000**	**$0**
Subtotal of Costs (Benefits) to Avista Utilities' Customers	**$1,912,778**	**($715,655)**
Proposed Management Fee	**($900,000)**	**($900,000)**
Net Additional Costs (Benefits) if Procurement Operations were to return to Avista Utilities	**$1,102,778**	**($1,615,655)**

disparate projections regarding the degree to which storage can be used to cover customer daily load volatility – swings around the average load – and the associated costs.

[70] *Id.*

63 After taking into account Avista's downward revision to $1.1 million of the estimated benefits from Avista Energy's performance under the Mechanism, the difference between the two is approximately $2.7 million. The primary areas of difference between Staff and Avista are related to: 1) currency risk; 2) load volatility; and 3) loss of transportation benefits. These items are discussed in more detail below.

a. Currency Risk

64 Avista includes a $176,000 cost in its benefits analysis related to currency risk. This entry is associated with Avista Energy's purchase of gas from its Canadian suppliers. These transactions are conducted in Canadian dollars. For these purchases, Avista is exposed to the risk of fluctuations in the exchange rate between the U.S. and Canadian dollars.[71] To derive its cost estimate, Avista analyzed the period from August 1, 2002, through August 1, 2003. For that period, Canadian currency strengthened against the U.S. dollar by 8.6 cents.[72]

65 Staff contends there is an equal possibility that the U.S. dollar will fluctuate upward as well as downward and that the period of time analyzed by Avista was not sufficient to reflect the full range of such currency fluctuations. Staff presented an analysis of Canadian currency exchange rates for the time period from September 1999 through February 2003.[73] This analysis showed that over the longer period, the Canadian dollar weakened against the U.S. dollar. Moreover, Staff points out that Avista acknowledges there can be significant exposure to currency shifts during each year, both upward and downward.[74] Finally, Staff argues that the $176,000 does not represent the amount required to

[71] *Exhibit 53T at 12.*
[72] *Id.*
[73] *Exhibit 63.*
[74] *Id.*

hedge the currency risk, even if there were one. For this reason, Staff assigned $0 for the cost to Avista Utilities of assuming the currency risk.

66 **Decision.** The Commission accepts the Staff proposal to value the risk of currency fluctuation at zero for purposes of this analysis. The historical experience of a single year has little value in determining likely future events. Staff's presentation is insufficient to permit normalization, and no party presented information about the cost of hedges that would reduce the risk. In the absence of sufficient evidence, the value of zero is appropriate.

b. Load Volatility.

67 This line item represents Avista's and Staff's efforts to measure Avista Energy's share of the benefits and costs for which Avista Utilities would be responsible if it performed the gas procurement function rather than Avista Energy. Avista initially estimated an annual cost of $231,000[75] under Avista Utilities' management of daily load volatility.[76] Avista contends that this amount represents the 20% of net costs Avista Energy is absorbing for this component through the 80/20 sharing mechanism.[77] Commission Staff estimated a net benefit of $1,759,855 if Avista Utilities were to manage commodity procurement.[78]

68 Commission Staff observes that most of the difference between it and Avista on this item relates to Staff's position that 20% of the benefits that would go to Avista Energy under the proposed Benchmark Mechanism would instead go to Avista Utilities, if gas procurement reverted to Avista Utilities. The total amount

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[75] *Exhibit 55C,*"Estimated Load Volatility," middle of the page.
[76] Load volatility in the context of this discussion is the measure of unexpected variations in load.
[77] *Exhibit 53T at 7*.
[78] *Exhibit 209C, ll. 1-10*.

involved in this aspect of the Staff's load volatility calculation is $1,538,422.[79] In its reply brief, Avista agreed with Staff's analysis.[80] This has the effect of reducing Avista's overall calculation of estimated benefits to Avista Utilities from the proposed Mechanism from $2.6 million to $1.1 million.

69 The only issues left in terms of the load volatility item are: i) Staff's contention that the cost of load volatility related to Tier 3 gas is zero,[81] and ii) Avista's contention that Staff double-counted storage benefits.

70 **i)** ***Tier 3 load volatility risk.*** Staff argues that load volatility risk for Tier 3 is zero because it can be avoided by use of storage to balance daily load.[82] Staff suggests that when loads are less than supplies, and the daily price is greater than the FOM index, the excess supplies could be sold in the daily market rather than injected into storage. When loads are greater than supplies, and the daily index is less than the FOM index, gas would be purchased at the daily rate rather than be withdrawn from storage. Staff contends that for the two months of the year when storage gas is not available (because gas cannot be injected or withdrawn), the potential costs to balance the daily load are minimal.[83]

71 Avista criticizes Staff's assertion that there is no cost to serve daily load volatility as unrealistic and based purely on Staff's "judgment" rather than on any objective considerations. Avista contends that it analyzed four scenarios that have occurred from September 1999 to February 2003, under which storage gas has been used in connection with Tier 3 load balancing.[84] The result of its

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[79] *Exhibit 209C, ll. 4,5, and 8.*
[80] *Avista reply brief at 15.*
[81] *Exhibit 209C, l. 3.*
[82] *Exhibit 201T at 33; T 482-483.*
[83] *T 481.*
[84] *Exhibit 102T at 8-9.*

analysis is that negative transactions dominate, and the net cost to Avista Energy has been over $7 million,[85] annualized to $2,261, 695.[86]

72 Staff in turn says that two of Avista's four scenarios are exactly the same as the beneficial offsetting situations Staff has identified. Furthermore, Staff claims that the costs associated with Avista's two negative scenarios could be avoided by either injecting gas into storage, rather than selling at a loss on the daily market, or by withdrawing gas from storage rather than buying gas at daily prices that are higher than FOM. Staff argues that Avista incorrectly assumes that in the two negative scenarios gas must be sold at a loss.[87]

73 **ii)** ***Double counting storage benefits.*** The second issue relates to Avista's contention that Staff double-counted storage benefits.[88] Avista argues that Staff improperly counted the benefits from use of storage in two places on Staff Exhibit 209C—once to reduce Load Volatility, and a second time to account for the storage Peaking Benefit .

74 Staff denies that it double counted storage benefits. Staff asserts that storage use to manage daily volatility is distinct from storage use to meet peaking needs. Each of these represents a different benefit of storage and, Staff contends, each needs to be counted separately.

75 **Decision**. We are persuaded that Staff's adjustment for load volatility is more credible than Avista's. We are not convinced by Avista's argument that prudent use of storage would only cover one-third of load volatility. We expect that Avista Utilities will prudently use storage to deal with load volatility by injecting

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[85] *Exhibit 55C,* Tier 3 P & L, Total.
[86] *Id,* Tier 3 P & L, Annual Average.
[87] *Staff initial brief at 42-43.*
[88] *Exhibit 53T at 8.*

gas into storage when demand and prices are low and withdrawing gas when demand and prices are high.[89]

c. Transportation Benefits.

76 The last contested item shown on Table 1 is the estimate of lost transportation benefits if the transportation management function is returned to Avista Utilities. Avista estimates a $2 million loss in capacity release and off-system sales. Staff estimates a loss of $0.

77 Avista's calculation of the $2 million uses actual capacity release/off-system sales revenue for the period the existing Mechanism has been in place. The period included two months during the "Energy Crisis" when Avista Energy captured approximately $10.4 million in such sales.[90]

78 Staff faults Avista's calculation because it includes the two anomaly months of Energy Crisis revenues. Staff's calculation normalizes Avista Energy's sales revenues for those months, and concludes that Avista Energy would provide $605, 742 less value than Avista Utilities.[91] Nevertheless, Staff entered a figure of $0 to be conservative.[92]

79 Avista responds that the Avista Utilities' sales figure that Staff uses as a starting point for its calculation was not normalized to exclude anomaly months, either.[93] Avista argues that Staff should either have normalized the estimated benefits Avista Utilities would have achieved, or have compared actual benefits for both Avista Energy and Avista Utilities. If Avista Utilities sales revenues are

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[89] *Staff initial brief at 41, ¶ 137.* These are two of four scenarios identified by Avista in its demand price matrix.
[90] *Exhibit 201T at 36.*
[91] *Exhibit 209C.*
[92] *Exhibit 201T at 3, ll. 10-12.*
[93] *Exhibit 214. See also, Avista initial brief at 41-42.*

normalized, Avista claims that management of transportation by Avista Energy would provide $1.6 million in benefits to ratepayers instead of the $2 million shown on Table 1.

80 Staff disputes the normalization of Avista Utilities' revenues proposed by Avista. Staff contends that, unlike the evident anomaly period related to the Avista Energy side of the equation, the data supporting the Utilities' side of the equation did not show the same anomaly.[94] Also, Staff objects to Avista's estimate that Avista Utilities would have only been able to achieve $1,571,950 in off system sales under normal utility practices.[95] Staff contends this is a three-year figure for Washington and Idaho and that it equals only about $381,040 per year, on average, for off-system sales margins in Washington, alone.[96] Staff argues that the $381,040 per year is an inadequate estimate in view of the fact that Avista Utilities achieved around $1.8 million in off-system sales margins for Washington and Idaho in 1995 and again in 1996, without the help of Avista Energy.[97] This amounted to $1,308,960 annually for Washington alone. Staff also contends that any estimate of the benefits that Avista Utilities would achieve should factor in changes in the market and recognize that Avista Utilities would do no worse today than it did before the Mechanism in capturing transportation benefits.[98] Finally, Staff observes that, pursuant to its calculations, even if Avista Utilities' "side" of the equation were normalized, the result is only a small net cost to Avista Utilities of approximately $230,000.[99]

81 **Decision.** We find it reasonable to presume that transferring the natural gas function to Avista Utilities will result in a cost to the utility of about $230,000 from lost transportation benefits. When using past data to project future costs it

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[94] *T 486.*
[95] *Exhibit 214; See also Avista initial brief at 44, Table 5, l. 14.*
[96] *Staff reply brief at 11-12; Avista initial brief at 44, Table 5.*
[97] *Exhibit 22 at C-9.*
[98] *T 273.*
[99] *Staff initial brief at 45.*

is important to normalize for anomalous events. Staff criticized Avista's first estimate of $2 million in lost benefits as coming primarily from two anomalous months. Avista, in turn, criticized Staff's analysis for excluding data from these months from the benefit calculation but including them when calculating costs. We think it reasonable, in this case, to exclude the data from these months when projecting both benefits and costs. Absent this data, Avista estimates loss of transmission benefits at $1.58 million, while Staff projects a $230,000 loss, if Avista Utilities takes over the Mechanism's functions. We find Staff's revised estimate that excludes anomaly revenues on both sides the more credible.

3. Unquantified elements.

82 Finally, though not determinative, we note that certain costs and benefits appear to be left out of Table 1. For example, the benefit to Avista Utilities from taking advantage of "Basin Optimization" opportunities is not quantified. Neither is there mention of any cost to Avista Utilities from the partial loss of cycling storage 100%. Finally, no value is assigned to Avista Energy's use of Avista Utilities' transportation and storage assets. The absence of these potential benefits and costs make us even more wary of concluding that we have the full picture of the benefits or disadvantages to Avista Utilities and to its ratepayers from the affiliated transaction involving Avista Energy.

4. Summary Regarding Benefits.

83 Table 2 reflects the Commission's decisions regarding the benefits and costs of the affiliated interest arrangement.

Table 2 Estimated Annual Incremental Costs Associated with Avista Utilities Managing Gas Procurement	
Commission Adjustments	
Expense Category	**(Benefit) or Cost**
Employee **(Loaded labor plus support costs)**	**$408,500**
Credit	**$512,500**
Premium for Physical Delivery	**$123,200**
Currency	**$0**
Load Volatility	**($1,759,855)**
Estimated Loss of Transportation Benefits	**$230,000**
Subtotal of Benefits to Avista Utilities	**($485,655)**
Proposed Management Fee Savings	**($900,000)**
Net Benefits if Procurement Operations were to return to Avista Utilities	**($1,385,655)[100]**

[100] This valuation is based on the Mechanism as proposed in Exhibit 153. However, Testimony by Mr. D'Arenzo, which was repeated in Avista's initial brief, appears to indicate that Avista would be willing to increase the guaranteed revenue from capacity release and off-system sales from $3 to $4 million. *T440 at 21-24 and Avista initial brief, pp.143.* The parties have not provided any calculations regarding the financial effect of this change. An assumption that Avista Utilities would generate less than $3 million in revenues from capacity release and off-system sales, a very low figure by historical standards, would decrease the estimate of "net benefits of returning procurement operations to Avista Utilities" by $1 million. Conversely, assuming revenues above $4 million, an estimate more in-line with past performance, decreases the "net benefits" estimate by only $200,000.

84 The Commission concludes that Avista has not demonstrated that the proposed affiliated interest arrangement contains sufficient benefits to Avista Utilities and ratepayers to outweigh the costs, the risks, and the uncertainties that are inherent in the proposal.

V. CONCLUSION

85 The Commission has carefully reviewed all of the evidence of record, and all of the parties' arguments. After doing so, we conclude the following.

Avista did not offer evidence of the costs to Avista Energy of the services or of the products that it would provide to Avista Utilities under the proposed Benchmark Mechanism, and it offered too few indicators of the market prices of services and commodity. Therefore, the Commission is unable to use a "lower of cost or market" test to evaluate the reasonableness of the proposed revised Tariff Schedule 163. Avista did present evidence that it argued showed that, in spite of the lack of cost or market price information, the Mechanism as proposed offered a structure that properly allocated risks to Avista Energy and Avista Utilities; utilized Avista Energy's market presence and expertise; and, absorbed many risks connected with the gas procurement function. However, our analysis leads us to conclude that the structure of the proposed Mechanism appears to create rewards to Avista Energy for merely tracking market trends, exposes Avista Energy to little risk, and calls for limited need to draw on Avista Energy's market expertise.

86 One of our concerns is the intentional or inadvertent use of the affiliated relationship to the disadvantage of ratepayers. We have faith in the integrity of Avista's management but we believe it necessary to ensure there are adequate safeguards to avoid any possibility of bias inherent in such a relationship. Avista has not demonstrated the existence of such safeguards against intentional or inadvertent manipulation in affiliate transactions under the Mechanism. Neither

do we find that Avista has demonstrated that there are significant and measurable benefits from the Mechanism for Avista Utilities and its ratepayers such as would offset the risks and uncertainties inherent in the relationship.

87 The Commission concludes, based on the record evidence taken as a whole, that Avista has not met its burden under RCW 80.16.030 to show that the proposed Benchmark Mechanism is reasonable.

88 The Commission rejects proposed Tariff Schedule No. 163.

89 **Response to dissent.** We acknowledge the differing views on this matter that our respected colleague and Chairwoman expresses in her dissent from this order. We agree with the dissent, and have stated above, that the abilities and the integrity of Avista's management are of the highest order. A proposed tariff schedule, however, must be supported by objective evidence just as in a typical rate case we require a demonstration by objective evidence of the costs and benefits of a previously-approved affiliated transaction to assure that rates are fair, just, and reasonable. In our judgment, this record fails to support the proposed tariff schedule with objective evidence that it is fair, just, and reasonable as a tariff or that it is reasonable -- not unduly beneficial to Avista Utilities, but providing a reasonable balance between costs and benefits -- as an affiliated interest transaction. Finally, this order does not say that Avista may never present a valid benchmark mechanism, and it acknowledges the Idaho and Oregon arrangements, leaving room for discussions of parties that develop a transition that coordinates with other Avista operations and provides the least disruption to the company and its ratepayers.

Consequences and further necessary steps.

90 We have already extended the term of the existing Benchmark Mechanism to February 14, 2004. Because we reject Avista's petition, the current Benchmark

Mechanism must be further extended for a short period of time to allow for the development of a transition plan.

91 We recognize that the parties have worked together successfully in the past to resolve regulatory challenges. We direct the parties to work together in this case to address solutions to the challenge of transition. We believe that a 60-day extension of the expiration date of Schedule 163 should allow the parties enough time to agree on a plan and a schedule for the transition and for Commission review and approval. We direct Avista to file a transition plan to deal with the consequences of this order within 30 days after the date of this order, or such later time as the Commission may approve by letter of the Secretary of the Commission. In developing the schedule for transition, the parties may consider that the Mechanism as it currently exists in Oregon and Idaho expires in March 2005. The Commission will consider a further extension of the expiration date, if necessary, depending on the plan we approve for transition of the Mechanism.

VI. FINDINGS OF FACT

92 Having discussed above all matters material to our decision, and having stated our general findings, the Commission now makes the following summary findings of fact. Those portions of the preceding discussion that include findings pertaining to the ultimate decisions of the Commission are incorporated by this reference.

93 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including electric companies.

94 (2) Avista is a "public service company" and a "natural gas company" as those terms are defined in RCW 80.04.010. Avista is engaged in

Washington State in the business of supplying utility services and commodities, including natural gas, to the public for compensation.

95 (3) Avista filed a petition requesting approval of an extension of the Natural Gas Benchmark Mechanism, as revised in proposed Tariff Schedule 163, on December 2, 2002. The Commission suspended operation of the tariff schedule, which was filed to become effective on April 1, 2003, by order entered January 29, 2003.

96 (4) The Commission convened an evidentiary hearing on the petition on November 24 and 25, 2003.

97 (5) Avista's proposed extension of the Benchmark Mechanism calls for Avista Energy to procure gas and manage transportation and storage on behalf of Avista Utilities, for compensation, including a management fee and the sharing of certain gains and losses with ratepayers. Avista Utilities would share 80% of the benefits and losses resulting from the operation of the Benchmark Mechanism. Avista Energy would share 20% of benefits and losses.

98 (6) By their common ownership and the terms of the agency agreement governing their relationship under the proposed Benchmark Mechanism, Avista Energy and Avista Utilities are affiliates.

99 (7) Chapter 80.16 RCW governs the criteria for Commission approval of transactions between affiliates.

100 (8) Avista failed to show that the proposed Benchmark Mechanism is reasonable, that is, that it would provide adequate safeguards against risks of financial bias toward the affiliate due to the affiliated nature of the proposed Mechanism or, in light of the lack of proof of costs and the risks

inherent in such arrangements, that it would provide significant, measurable benefit to ratepayers.

101 (9) Avista will require some additional time beyond the expiration of the current mechanism to plan and effect the transition of the current Benchmark Mechanism functions from Avista Energy to Avista Utilities.

VII. CONCLUSIONS OF LAW

102 Having discussed above in detail all matters material to our decision, and having stated general findings and conclusions, the Commission now makes the following summary conclusions of law. Those portions of the preceding detailed discussion that state conclusions pertaining to the ultimate decisions of the Commission are incorporated by this reference.

103 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to, this proceeding. *Title 80 RCW.*

104 (2) Avista Energy and Avista Utilities are affiliates. *RCW 80.16.010.*

105 (3) The proposed Benchmark Mechanism, Tariff Schedule 163, constitutes an affiliated transaction. *RCW 80.16.010.*

106 (4) Avista failed to meet its burden of proof that the Benchmark Mechanism, as an affiliated transaction, is reasonable. *RCW 80.16.030; RCW 80.16.040.*

107 (5) The petition for extension of the Natural Gas Benchmark Mechanism, as contained in the suspended Tariff Schedule 163 and as revised during the course of the hearing, should be rejected.

108 (6) The Commission should direct the parties to the proceeding to consult in the development of a plan to transition from Avista Energy to Avista Utilities the gas procurement and transportation and storage management functions performed by Avista Energy under the current Benchmark Mechanism.

109 (7) The Commission should retain jurisdiction over the subject matter and the Parties to this proceeding to effectuate the terms of this Order. *Title 80 RCW*.

VIII. ORDER

110 THE COMMISSION ORDERS That Avista's petition for the extension of the Natural Gas Benchmark Mechanism Tariff is rejected.

111 THE COMMISSION FURTHER ORDERS That the February 14, 2004, expiration date of the current Tariff Schedule 163 is extended for 60 days after the date of this Order. The parties are directed to collaborate in the development of a transition plan subsequent to the entry of this order, and Avista is directed to present a proposed compliance recommendation for the transition of the Benchmark Mechanism functions now being performed by Avista from Avista Energy back to Avista. In their deliberations, the parties may consider that the Benchmark Mechanism in effect in Idaho and Oregon expires in March 2005. Thirty days from the date of this Order, Avista must file a transition recommendation with the Commission. The Commission will consider the transition recommendation and grant a further extension of the expiration date of the current mechanism if necessary.

Dated at Olympia, Washington, and effective this 13th day of February, 2004.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

RICHARD HEMSTAD, Commissioner

PATRICK J. OSHIE, Commissioner

112 CHAIRWOMAN MARILYN SHOWALTER, Dissenting:

I. SUMMARY

113 In my view, the majority's test for whether this affiliated-interest agreement is "reasonable" is conceptually flawed and unduly limiting. I would balance a number of factors and find the agreement, as adjusted below, to be reasonable within the meaning of the governing statute.

114 I would approve the proposed Mechanism with the following changes:

A. Raise the $3 million guarantee to $4 million. Consistent with Mr. D'Arienzo's testimony and the position Avista takes in its post-hearing brief, substitute $4 million, paid by Avista Energy to Avista Utilities, for the $3 million guarantee from transportation revenues under the proposed Mechanism. Compared to the proposed Mechanism, this increases benefits for the ratepayers by means of a certainty of receiving the incremental $1 million, instead of a probability less than 1 of receiving $800,000 (under the proposed Mechanism). Compared to Avista Utilities taking back the gas-procurement task, this modification would bring ratepayers the certainty of receiving $4 million, instead of a probability less than 1 of Avista Utilities (on its own) making at least $4 million from transportation benefits.

B. **De-couple the $4 million guarantee from transportation revenues, and make it a $4 million threshold.** Provide that Avista Utilities is guaranteed $4 million, with an 80/20 sharing of all benefits above $4 million, and an 80/20 sharing of all costs. ("Benefits" and "costs" here means amounts above or below the benchmarks, in favor or adverse, respectively, to Avista Utilities.) This eliminates any incentive to "game" the components of the Mechanism, and answers footnote 2 on page 6 of Staff's Reply Brief. One can further simplify the equation by offsetting the $900,000 Avista Utilities pays to Avista Energy. Thus, Avista Energy would pay Avista Utilities $3.1 million, share 80/20 benefits exceeding $4 million, share 80/20 all costs, and deliver and manage all gas procurement for Avista Utilities.

C. **Shorten the time period of the Mechanism, to terminate March 31, 2005.** Though a longer term would normally be appropriate, a March 2005 date will coincide with the termination dates of similar mechanisms in Idaho and Oregon, and thereby 1) allow all three states to coordinate, if feasible, consideration of any new proposal; 2) minimize the possibility of extra total costs—in the coming year and after—that would likely result if the states simply go their own ways; and 3) give everyone (the other states included) another set of data—Washington's data under the revised Mechanism—to evaluate.

II. MEMORANDUM

A. Nature of Agreement

115 The agreement proposed between Avista Utilities and Avista Energy has three aspects that, for evaluation purposes, yield a complicated interplay:

- Aspect 1: Affiliated-interest agreement
- Aspect 2: Hedging agreement
- Aspect 3: Incentive agreement, based on a benchmark mechanism

Affiliated-Interest Agreement

116 There is inherent risk to ratepayers in a non-arm's length transaction between a regulated company and an affiliate. The majority has correctly identified this risk as the incentive of management, which controls both companies, to benefit shareholders at the expense of ratepayers. (This risk is also present within a regulated company.) Therefore, any affiliated-interest agreement requires scrutiny, to see that it guards against cross-subsidies or unfair biases favoring the non-regulated company.

117 There can also, however, be inherent synergy or efficiency in affiliate-interest relationships. Unlike non-related companies, a regulated company and its affiliate share profits, share facilities, share a cooperative relationship, and share an interest in seeing each other thrive because both have common stockholders and because the financial health of one affects the financial health of the other. Also, the CEO of the affiliate has an on-going relationship to the regulator of the regulated company. While shareholders may have a short-run incentive to "take advantage of" the ratepayers, over the long run shareholders benefit from a regulated utility that is well-run, lean, and fair to its customers. Otherwise, the customers may exercise alternatives, including shutting down, seeking self-

service or service from a neighboring utility, or seeking forms of legislative or regulatory relief—any of which could be adverse to the shareholders.

118 Under our statutes, we must find that the regulated company has demonstrated that an affiliated-interest agreement is "reasonable." As more fully discussed below, the challenge of this case is how (by what method) to determine whether an affiliated-interest agreement is reasonable, when the agreement includes hedging and incentive mechanisms.

Hedging Agreement

119 Hedging is an aspect, in a sense, of almost any contract for services—an entity transfers to a contractor the risks associated with doing a particular task. Here, Avista Utilities would shift to Avista Energy the risk of delivery, counter-party default, credit of trading partners, and currency fluctuation. In addition, through the incentive mechanism Avista Utilities would hedge its risk of financial losses by shifting 20% of any loss to Avista Energy.

120 Generally, when reviewing a hedging agreement, the relevant question is whether the price paid for the hedge is worth the certainty gained or risk reduced. This is never an exact science, even if the exact cost of the hedge is known, because one cannot know what the future will be without the hedge, and because it is difficult to place an absolute value on the avoidance of uncertain risk.

Incentive mechanism

121 An incentive mechanism rewards a provider for a better performance (sometimes compared to a benchmark) and/or penalizes it for a worse performance. The agreement in this case sets up incentives and disincentives applicable to Tier 3 purchases, capacity release and off-system sales, storage, and basin optimization.

122 Generally, when reviewing an incentive mechanism, one will want to evaluate whether the arrangement fairly shares risks and rewards, and whether the mechanism aligns the interests of the parties so as to motivate the service provider (in this case, Avista Energy) to bring greater benefit to the purchaser (in this case, Avista Utilities and the ratepayers). Again, the inability to predict the future with certainty means an inability to evaluate, with certainty, the effects of the mechanism. Rather, the incentive mechanism is a partial substitute for what would otherwise be a more finite exchange of services or product for dollars. It is this aspect, more than any other, that strains the use of a traditional cost-benefit analysis of such an arrangement.

B. Problem with majority's test for reasonableness

123 The majority observes, correctly, that a "lower of cost or market" test is inapplicable to this case. The majority determines, appropriately in my view, that the inapplicability of that test and the absence of a competitive bidding process do not preclude further analysis of whether the agreement is "reasonable."

124 Where I part company with the majority is in its formulation of a test for determining reasonableness under these circumstances. The majority determines that Avista has not demonstrated that the Mechanism contains adequate safeguards against favoritism toward the affiliate.[101] Then, with no particular

[101] The majority recounts the primary flaw in the *current* (not the proposed) mechanism, which is asymmetry among components of the mechanism with respect to sharing of costs and benefits. But this problem has been fixed with the uniform 80/20 sharing formula. The remaining identified problem can be fixed, as I have outlined, by decoupling the $3 million (or $4 million) guarantee from transportation benefits.

rationale, it sets up an equation in which the net benefits of the agreement must be weighed against the absence of proof that Avista won't favor the affiliate. The majority demands, as proof of reasonableness, that there be "significant, measurable benefits to ratepayers sufficient to offset the uncertainties and lack of safeguards inherent in the affiliated transactions."[102]

125 The first problem with this equation is that, by definition, one side is unknown and undefined—the "uncertainties and lack of safeguards inherent in affiliated transactions." So it likely will be impossible ever to satisfy the test with a showing of sufficient benefits on "the other side" of the equation.

126 The second problem is the requirement that there be "significant" benefits. In most business transactions, the costs and risks are roughly comparable to the benefits and opportunities. One should not expect a contract to be lopsidedly beneficial to one side or the other. Rather, a reasonable agreement should produce a fair exchange of costs, risks, benefits, and opportunities for each party. Avista Utilities should get roughly what it pays for, not "significantly" more than it pays for. Here, too, the majority's test is likely never to be satisfied.

127 The third problem is that the benefits must be "measurable." The idea that a benefit doesn't count unless it's measurable is a trap we should avoid. There are many aspects of utility operation and regulation that cannot be quantified and yet are important (even "significant"). In this case, a few of these aspects include: the overall ability and integrity of top management; the expertise and trading relationships of the affiliate; the multi-state nature of the utility's operations and the relationship of our state's ratepayers and commission to the ratepayers and commissions of other states; and the incentive to perform, which

The majority also complains that the 80/20 ratio has not been justified. In my view, the ratio is not as important as its symmetrical application and the base fees/guarantees on top of which it operates. A 50/50 sharing could be just as appropriate; it is just a tighter hedge – up and down- against volatility. Reasonable agreements could contain tighter or wider bands.

cannot be definitively quantitatively compared to performance without the incentive, because one will never know what the performance without the incentive "would have" been. All of these aspects contribute importantly to my evaluation of the reasonableness of the agreement, even though they cannot be quantified.

128 Even most of the costs and benefits that have dollars attached to them are not really measurable. Rather, they are based on forecasts or other judgments that produce a number. So, for example, Staff forecasts a dollar-value for transportation benefits based on *its* judgment, and the company forecasts a different value based on *its* judgment. The only truly measurable items in the agreement are the $900,000 fee paid by Avista Utilities, and the $3 million (I would make it $4 million) threshold "paid" to Avista Utilities. Everything else is projection, prediction, and judgment, albeit with degrees of support from quantitative data from the past.

129 The fourth problem is the majority's insistence on a finding of "benefits." In any judgment we make that is forward-looking and involves numerous cross-currents of quantitative and non-quantitative factors, (especially including sharing of unknown future costs and benefits), it will not be possible, definitively, to show there will be benefits, for the simple reason that one cannot predict the future. That is why "reasonableness" is a better test.[103]

130 Part of the problem lies with the majority's attempt to use approaches developed in ratemaking, which uses a backward-looking "test year" and known and measurable costs, to which various adjustments are made. Here, we are evaluating a forward-looking mechanism that is meant to alter behavior, in a beneficial way, from what it might otherwise be without the mechanism. We

[102] Order at paragraph 46. This test is also expressed in paragraphs 8, 9, and 86.
[103] The standards "fair, just, and reasonable" and "consistent with the public interest" share the same appropriate quality.

don't know what will occur in the future, with or without the mechanism. We therefore cannot measure, with any precision, the difference between these two alternatives.

131 We can—and should—make informed judgments, taking into account all of the quantitative and qualitative information at our disposal. It is neither possible nor desirable to reduce all of this information to numbers that can then be offset against each other to produce a bottom-line, "significant" "benefit," which is then further offset against an unknown and undefined lack of a safeguard. It *is* possible, though, to evaluate and balance all factors to determine whether an agreement is "reasonable."

132 The majority appears locked into the idea that it must make a choice between Avista's estimates, on the one hand, or Staff's estimates, on the other. This, too, is typical of the ratemaking process, where the Commission ultimately must pick some number—for return on equity, for salaries, for legal expenses, etc.—in order to determine a revenue requirement and rates. This approach is not a good fit, however, for evaluating the effects of a Mechanism on future behavior. Generally, when forecasting the future, whether of numerical units or behavioral dynamics, it is wise to admit of a *band* of reasonableness. Using the band concept, it is possible that two different estimates or agreements are *both* reasonable. It is also possible (and probable) that the band of reasonableness narrows over time, as experience produces better insights and refinements in methodology.

133 Using a "band" of reasonableness, within which a number of forms of agreements might fall, is akin to determining "prudence." In a prudence proceeding, we try to evaluate the company's actions in light of what it knew, or should have known, at the time it made its decisions. Generally, we don't hold the company to a single acceptable course of action, but rather we recognize a range of actions that might have been prudent (as evidenced by our acceptance of different companies pursuing different paths). There is a difference, however, between a finding of prudency and the case in front of us. In a prudency finding, we are looking backward and approving or disapproving actions that have occurred. Here, the actions have not yet occurred; we are only looking at a proposal governing future actions. We really are in the place we only pretend to be in determining prudency: looking into an unknown future and trying to determine a reasonable approach to it.

134 There is one more way in which this case differs from typical ratemaking. In a rate case, if the company does not bear its burden of demonstrating a cost-element, that element (or at least the incremental amount requested) is not included in the calculation of the company's revenue requirement, and consequently the ratepayers don't pay it. Here, however, a failure of proof relating to an element of an agreement does not mean the ratepayers won't pay for that element. For example, setting expenses for containment of currency risk at "$0" on the ground that Avista failed to support its figure of $176,000 does not mean the ratepayers will pay nothing for being protected from currency risk, if Avista Utilities takes back the gas-procurement function and hedges that risk. This is just a small example, but it illustrates the point that our task here is not determining whether the company has proved legitimate fixed costs upon penalty of losing recovery of them in rates, but rather determining whether an agreement is a reasonable way to manage future risks, costs, and opportunities that the ratepayers will face even without the agreement.

C. Factors bearing on reasonableness—my view.

135 In this case, the Commission should determine whether the Mechanism reasonably balances risks, opportunities, costs, and benefits between the ratepayers and the company (represented here by the affiliate), after carefully scrutinizing and weighing the following non-exclusive factors:[104]

- Magnitude of potential gain or loss

- Term of the agreement

- Relative abilities of affiliate vs. regulated company to perform a given function. This includes factors such as comparative size, depth, breadth, ability to pool assets, risk profile, number of trading partners, etc.

- Appropriateness of benchmarks and where they are set

- Fees and sharing arrangement

- Alignment or misalignment of incentives, between the regulated company and the affiliate, as reflected in the benchmarks, fees, and sharing arrangement

- Ability to track or audit performance under the mechanism

- The interplay of Avista's obligation to Washington and its ratepayers, and its obligations in Idaho and Oregon.

- The prospects for on-going refinement and improvement in the benchmark mechanism.

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[104] This list should not be taken as a suggested "recipe" to use in future cases. (As part of a dissent, there's little chance of this, anyway.) There is a tendency in some quarters to seize upon factors listed in one case, and exalt them to a general test in later cases. To the extent the cases present similar issues, the same factors may be appropriate. To the extent the facts or issues are different, such a list may be incomplete or off-base. One should always keep the ultimate, statutory tests in mind.

Magnitude of potential gain or loss

136 The smaller the magnitude of potential gain or loss, the less concern the Commission should have for bias toward the affiliate, especially if it cannot articulate what form the bias might take.

137 Here, the parties are arguing over whether Avista Energy or Avista Utilities should take on management functions that represent 1-2% of the total costs of gas procurement.[105] If there are additional, unknown advantages to Avista Energy, they are on the margins of that 2%. In another measure of magnitude, Avista estimates a 1.4% advantage to the ratepayers of Avista Energy performing the gas-purchase function. Staff estimates a 2.1% advantage of Avista Utilities performing the function. This relatively narrow range is not determinative, of course, but it sets the general limits *within which* other factors are at play.

Term of the agreement

138 The shorter the term of the agreement, the less concern the Commission should have for the inevitable uncertainty that any forward-looking incentive mechanism poses. A shorter term offers the possibility of timely correction or, if no promising improvements can be made, termination. Like the first factor, above, a short timeframe constrains the effects—positive or negative—of the other features of the agreement.

139 Here, the term I recommend is very short—just one year. The amount of unexpected or unwarranted loss or gain that can occur is likewise limited.

[105] In Table 2, the majority estimates a $1.4 million benefit if it takes over managing the gas procurement operations. This figure is 1.8% of the total $76.3 million spent on these activities from April '02 to March '03.

(Ordinarily, I think a somewhat longer term would be appropriate, but a shorter term would synchronize with Idaho and Oregon.)

140 Taken together, the relatively narrow magnitude and short timeframe offer effective constraints within which the other elements may be judged, and within which the "uncertainties" should be viewed.

Relative abilities of the affiliate vs. the regulated company to perform a given function

141 This issue is key. If Avista Utilities can do just as well as Avista Energy in the gas-procurement function, there's no real reason to contract with Avista Energy to do the job. In large part, the majority finds this to be the case, rejecting Avista's claims of the advantages Avista Energy can offer.[106]

142 In my view, the majority has given insufficient weight to several factors. Avista Energy is some 30 times bigger in trading volume than Avista Utilities. Scale matters. By an order of magnitude or more, Avista Energy has more trades, more trading partners, more opportunities for offsetting trades, more flexibility and choices among capacity release, off-system sales and basin optimization, more ability to maintain a broad and deep trading staff, etc. The majority discounts these features, observing that because Avista Utilities management already makes the final trading decisions, it can be successful in taking over the whole gas-procurement function. This observation misses the point: now, Avista Utilities is permitted to take advantage of Avista Energy's operations; if Avista Utilities takes back the gas-procurement function, it will not be able to make the same decisions, because it will not be able to benefit from (or even be privy to) the range of choices provide through Avista Energy's scale, flexibility, and expertise.

[106] Order at paragraphs 57 – 60, 75, and 81.

143 The majority has given insufficient weight (actually no weight) to Avista Energy's greater ability to manage load volatility, compared to Avista Utilities's ability. There is some irony in the majority's insistence that Avista Utilities can do just as good a job, even though Avista Utilities's management —Vice President Kelly Norwood—testified that Avista Utilities cannot do just as good a job, because Avista Utilities cannot take the same risks with storage. The response to Bench Request 1 demonstrates that Mr. Norwood's testimony is well-founded. Since the mechanism was initiated, load volatility costs have been: \$72,054 in 1999 (September – December); \$8,313,677 in 2000; \$351,051 in 2001; and \$342,513 in 2002. It is unrealistic to assume, as the majority does, that the cost is \$0.

144 Similarly unrealistic is the majority's conclusion regarding transportation risks and benefits. The majority adopts Staff's estimate of Avista Utilities's foregone transportation benefits (after removing data from two anomalous months) under the Mechanism. Staff's argument against Avista's estimate was that its projection of off-system sales revenue was unreasonably low. However, Avista's estimate (\$381,000) is not significantly different and indeed is above what was achieved in 2002 (\$270,000).[107] More importantly, Staff has not taken into account the \$5,181,000 in Avista's projected revenue from capacity release activities.[108] This level of capacity-release revenue is higher than was earned in any year since a mechanism has been in use. And Avista's projection is substantially higher than the \$3.6 million, \$3.3 million, and \$4.7 million that Avista Utilities earned when it managed gas supply in 1996, 1997, and 1998. The relatively small off-system sales projection is not surprising, given the high revenue predicted from capacity release. Both capacity release and off-system sales vie for the same

[107] Response to Bench Request 2. This \$270,000 figure represents an extrapolation of data provided in response to Bench Request 2. That data indicates that Avista earned \$200,000 in off-system sales over the first nine months of 2002. Grossing up \$200,000 to an entire year results in the \$270,000 revenue projection.

excess pipeline capacity. Given the straightforward explanation of the low level of off-system sales in Avista's projection and the absence of other criticisms of Avista's calculations, I find Avista's figure to be reasonable.

Appropriateness of benchmarks and where they are set

Fees and sharing arrangement

Alignment or misalignment of incentives, between the regulated company and the affiliate, as reflected in the benchmarks, fees, and sharing arrangement

145 These factors are all related, and, like any contract, must be evaluated as a package. In general, as is already evident, I find it a reasonable arrangement, with two modifications.

146 As Staff observes, the proposed Mechanism contains an asymmetrical approach to two components that in fact are partial substitutes for one another: capacity release and off-system sales, on one hand, and basin optimization, on the other. Staff points out that Avista Energy has an incentive to favor capacity release and off-system sales over basin optimization, because Avista Energy must guarantee Avista Utilities $3 million in revenues from capacity release and off-system sales.

147 This feature of the proposed Mechanism can be fixed by de-coupling the guarantee from any component. After all, while the rationale for the guarantee is rooted in estimates of capacity release and off-system sales, the guarantee itself is just money. If the guarantee is decoupled from any component, but the 80/20 sharing of benefits remains (after the guaranteed amount has been reached), Avista Energy will be motivated, at any given time, to look for the best alternative among all components.

[108] See Avista Initial Brief, Table 5, p.44.

148 The second feature I would change is the amount of the guarantee. In both testimony and on brief, Avista represented that it could accept a $4 million guarantee. I would hold them to it. As a result, benefits to the ratepayers would increase. Compared to the proposed Mechanism, this adjustment would increase benefits for the ratepayers by means of a certainty of receiving the incremental $1 million, instead of a probability less than 1 of receiving $800,000 (under the proposed Mechanism). Compared to Avista Utilities taking back the gas-procurement function, the ratepayers would have the certainty of receiving $4 million, instead of a probability less than 1 of Avista Utilities making at least $4 million from transportation benefits.

149 These two adjustments bring the proposal closer to the center of a range of reasonableness.

Ability to track or audit performance under the mechanism

150 At the surface, the Mechanism is fully auditable. Staff's concern is with looking behind the mechanism to see what Avista Energy is really doing and how it might really be benefiting from the agreement. I think the Mechanism itself is the substitute for accounting for "real costs." If the Mechanism itself is reasonable and trackable, there is no need to look behind it. Further, the constraints of magnitude and term, discussed above, significantly blunt these concerns.

The interplay of Avista's obligation to Washington and its ratepayers, and its obligations in Idaho and Oregon

151 We are tied to our neighbors, through Avista, in several ways. First, if Avista can have a common approach to gas procurement in all three states, the likely efficiencies will benefit all of us. Second, even if the states end up going their own ways, it is neither desirable nor courteous for one state or for the company or a party to "leverage" the other states in non-synchronized proceedings. On the contrary, the three state commissions and their staffs and the parties can benefit from each other if we are examining the Mechanism roughly contemporaneously.

152 A common termination date would foster state coordination and cooperation. I would terminate the Benchmark in March 2005, with the expectation that the Company would make a similar proposal in all three states at that time.[109]

The prospects for on-going refinement and improvement in the benchmark mechanism

153 Incentive mechanisms are still relatively new to energy regulation, and incentive mechanisms performed by affiliates are even more uncommon. The effect of the majority opinion, I fear, will be to close the door on incentive mechanisms performed by affiliates and cast some doubt on incentive mechanisms in general. If so, it will be a result that is unfortunate and unnecessary. The Mechanism has improved with each iteration, and would improve as a result of this proceeding, if it were allowed to continue as I have outlined.

154 We should also remember that the original impetus for incentive mechanisms was a frustration with the pass-through of fuel costs, with little incentive to the company, other than a later prudence-review, to work diligently to save the ratepayers money. If in order to avoid "uncertainty" we revert to low or no incentives, we may again be left with only after-the-fact prudence reviews (which have their own degrees of subjectivity). If the company adopts a timid

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[109] The majority intimates that it may be open to an extended transition period for the parties to effectuate its order. It has already precluded, however, continuation by Avista Energy of the gas-procurement function. So, unfortunately, Washington will not be able to cooperate with the other states if they wish to continue the arrangement. To the contrary, because Washington dominates in share of Avista's customers, it is likely that Washington's decision today will constrain the options for the other states.

approach in order to cope with the uncertainty of prudence reviews, what will we have gained?

III. CONCLUSION

155 The proposed agreement, as I would modify it, is of limited duration and of limited magnitude with respect to potential gains and losses for the ratepayers of Avista Utilities. It aligns the interests of Avista utilities and Avista Energy so as to motivate Avista Energy to make economical use of its considerable resources on Avista Utilities's behalf. Taken as a whole, the terms and conditions of the agreement, as modified, are reasonable and should be approved.

156 For these reasons, I respectfully dissent.

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Marilyn Showalter, Chairwoman

NOTICE TO PARTIES: This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-07-870.