BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

DIRECT TESTIMONY OF ROBERT H. GRUBER (RHG-1T)

REPRESENTING AVISTA CORPORATION

## I. INTRODUCTION

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

A. My name is Robert H. Gruber. I am employed as Manager of Natural Gas Resources by Avista Corporation at 1411 East Mission Avenue, Spokane Washington.

**Q. Please briefly describe your educational background and professional experience.**

A. I am a graduate of Southern Oregon College with a Bachelor of Science degree in Business Administration. I have worked in the Utility industry for 36 years in various positions in field operations, administrative and management positions. I have spent the last fourteen years in natural gas supply and planning roles. I joined the company in 1991 and was appointed to my present position in 1999. In this role I am responsible for administrative oversight of the agency agreement with Avista Energy, long-term planning for natural gas resources, Federal regulatory oversight, pipeline relations, gas supply oversight for non-Benchmark properties and fuel supply for the Utility's natural gas thermal generation.

**Q. Have you testified in regulatory proceedings before?**

A. Yes, I have presented testimony in various rate, tariff and regulatory proceedings before the Utility Commissions in Oregon, California, Nevada, Idaho, Utah and Arizona.

Q. **Are you sponsoring any Exhibits in this proceeding?**

A. Yes, I am sponsoring Exhibit_____ (RHG-2), which was prepared under my direction.

## II. OVERVIEW

**Q. Please describe the nature of your testimony in this proceeding.**

A. My testimony will present an overview of the relationship between Avista Utilities and Avista Energy with respect to the Natural Gas Benchmark Mechanism (hereafter referred to as Benchmark or Mechanism). In this discussion I will review the various components of the Benchmark, the benefits provided by Avista Energy and why the Benchmark is important to the Utility and its customers. I will also review modifications to the Benchmark that the Company is proposing in this filing that address concerns presented by the Commission Staff.

**Q. Please proceed with an overview of the relationship between Avista Utilities and Avista Energy.**

A. In order to provide clarity to the Benchmark Mechanism, we have developed a series of graphic representations of the major components. Please refer to page 2 of Mr. Norwood's Exhibit____(KON-2). This graphic gives an overview of the corporate relationship of Avista Utilities and Avista Energy. It also lists the major functions of each entity as it relates to providing gas resource management and supply to the Utility's customers. Avista Utilities is an operating division of Avista Corporation, and Avista Energy is a wholly owned subsidiary of Avista Corporation. Under the Benchmark, responsibilities of the Utility include oversight of the Benchmark for the benefit of customers, resource accounting, metering and the provision of metered data and load forecasts for core customers to Avista Energy. The Utility is also responsible for long term planning and maintaining pipeline assets in the form of transportation contracts on the

various pipelines that serve the Utility. As shown on this slide, gas procurement services have been outsourced to Avista Energy under the Benchmark Mechanism.

**Q. What services does Avista Energy perform under the Mechanism?**

A. The procurement and management services provided to Avista Utilities by Avista Energy include three basic components. The first of these components is commodity, where gas volumes are purchased under a diversified portfolio approach that we believe will provide an appropriate balance of lowest cost supply and price stability over time. We are proposing an 80%/20% sharing of the costs and benefits associated with managing the daily variability of loads, and optimizing supply from the lowest cost basin(s) to provide an incentive for Avista Energy to achieve the lowest possible costs for reliable supply.

Second is the Jackson Prairie Storage Facility (Jackson Prairie) Component, which provides savings to customers in the form of the differential in price between summer and winter, coverage of peak day reliability, and the ability to offset daily priced gas supplies under certain conditions throughout the seasons. Under the proposed Mechanism, Avista Energy would guarantee a 100% cycle of injections and withdrawals from Jackson Prairie, and the costs and benefits would be shared symmetrically at 80% to customers and 20% to Avista Energy. In addition, injections and withdrawals would be made to cover daily load variations as long as it does not jeopardize the reliability of supply.

Third is the transportation component, which includes both capacity release and off-system sales and provides benefits to customers from the optimization of all pipeline capacity reserved for the Utility's customers. Under this component Avista Energy provides

a $3 million guarantee with an 80/20 sharing. Additional details related to the three components will be discussed in more detail later in my testimony.

**Q. If the gas procurement function were returned to the Utility how would the procurement portfolio be managed?**

A. The fundamental procurement and asset management strategy would be very similar. With respect to commodity, the Utility would purchase fixed price products for a portion of the customer's needs, acquire some commodity based on first of the month index, with the balance coming out of storage or purchased in the daily market.

Storage would be primarily used to mitigate costs with a structured summer-winter differential purchase and withdrawal schedule. Storage would also be used to mitigate high day prices and cover some load swings with a primary focus on maintaining deliverability for peak day reliability because approximately one-third of core peak day requirements are covered with storage.

The pipeline transportation portfolio would be optimized using a combination of capacity releases and off-system sales. This approach provides customers with reliable supplies and a reasonable level of price stability.

Additionally, when we began the Benchmark Mechanism in 1999, several employees in the Utility Gas Procurement area were reassigned or left the company. These employees would have to be replaced and I will discuss the costs associated with these changes as well as other costs of bringing the Benchmark back into the Utility later in my testimony.

## III. BENEFITS TO UTILITY CUSTOMERS

**Q. What benefits does the Benchmark Mechanism provide to the customers of Avista Utilities?**

A. A summary listing of the benefits provided to Utility customers is shown on page 1 of Exhibit_____(RHG-2). These benefits include economies of scale associated with being part of a much larger portfolio, expertise in the trading area, more sophisticated tools for market analysis, and access to additional markets. In addition, consolidation of gas procurement operations under Avista Energy has shifted many of the costs and risks associated with gas procurement operations from the Utility and its customers to Avista Energy. Because of changes in the market, costs and risks to Avista Energy associated with management of gas procurement for the Utility have increased significantly since the original Mechanism started in 1999. Some of these risks and costs include market liquidity, administrative costs, currency and credit risks, management of intra-month price volatility, nomination errors, risk of non-payment by counterparties, and some of the operational flow order risk and entitlement risk. A conservative estimate of the savings to Avista Utilities' customers from Avista Energy bearing these costs and risks is approximately $1.5 million annually.

In addition, Avista Energy engages in more active management of off-system sales, which has provided greater monetary benefits to customers than could be realized under a smaller-scale utility operation. Volatile market conditions with wide price disparities between receipt and delivery points of transport have enabled Avista Energy to optimize off-system sales. Through the management of unutilized capacity within the Mechanism, Avista

Utilities' customers receive the market value of the capacity (the market price difference between basins). Through analysis by the Utility of the capacity release and off-system sales, it is estimated that customers received approximately $2 million additional benefits per year more than the Utility would have achieved because of a lower Utility risk tolerance.

Therefore, the value to Avista Utilities' customers from Avista Energy managing the procurement operations is approximately $3.5 million annually. The Company is proposing to eliminate the 5 cents per dekatherm adder in the current Mechanism, and replace it with a $900,000 per year management fee. The purpose of the management fee is to cover a portion of the risks and costs being borne by Avista Energy. On a net basis, therefore, we believe that our customers will realize benefits of approximately $2.6 million annually through the proposed Mechanism.

Stated another way, if the natural gas procurement operations were to return to the Utility, it would result in a net increase in expenses and lost benefits from transportation and capacity releases of approximately $2.6 million annually, as summarized in the table below. The Benchmark is important to the Utility and its customers, because it provides lower costs to customers than could be achieved by the Utility.

| TABLE 1<br>Estimated Annual Incremental Costs associated with<br>Natural Gas Procurement Managed by the Utility vs. Avista Energy | |
|---|---|
| Expense Category | **Avista Utilities Managing Gas Procurement** |
| Employee (loaded labor plus support costs) | $408,500 |
| Credit | $512,500 |
| Premium for Physical Delivery | $123,200 |
| Currency | $176,000 |
| Load Volatility (1) | $231,000 |
| Estimated Loss of Transportation Benefits and Off-System Sales | $2,000,000 |
| **Subtotal of benefits to Utility Customers** | **$3,451,200** |
| Proposed Management Fee | **($900,000)** |
| **Net Additional Costs if Procurement Operations were to return to the Utility** | **$2,551,200** |
| (1) This valuation is Avista Energy's estimated share of the daily swing around the average due to customer load volatility (net of shared total basin optimization benefits). | |

**Q. Please further explain the estimated increase in administrative costs if the natural gas procurement operations were returned to the utility?**

A. Recent changes in wholesale markets have increased the complexity of gas procurement operations. If the current Mechanism were brought back into the Utility, the incremental administrative costs would involve, at a minimum, four to five additional employees and associated support costs such as training, travel, computers, etc. The Company has determined that the estimated cost for loaded labor and miscellaneous administration costs for Washington customers would be approximately $408,500. This amount assumes that Avista Energy would continue managing the Mechanism for Idaho and

Oregon customers, and that these incremental costs would be directly assigned to Washington.

**Q. Please explain the estimated increase in cost in Credit, Premium for Physical Delivery, Currency, and Load Volatility that are referenced in Table 1 above.**

A. Changes in market conditions in the energy sector have resulted in a number of changes that would result in increased costs to the Utility if the current Mechanism were brought back.

One of the most significant changes in the market has been around credit. Since mid-2000, market conditions in the energy sector have resulted in increased difficulty for gas traders and utilities to locate counterparties willing to sell to them on an unsecured basis. The $512,500 reflected on the table is our estimate of the cost of the credit facility that would enable the Utility to post collateral in the form of Letters of Credit or cash with counterparties to allow the Utility to purchase gas for its customers.

The premium for physical delivery is a result of the fact that the gas market trades two fundamental products, financial and physical. All of the fixed price products that result in Tier 1 fixed price deliveries to customers are done with financial instruments. The physical gas for Tiers 1 and 2 is then purchased at First of Month index, which is a physical product. To assure availability of physical deliveries it is necessary to purchase an index product at a premium. The physical premiums are listed in detail for each supply basin in the workpapers. The total cost of this premium is $123,200.

Currency risk is a result of the fact that a large portion of our supply is based at AECO in US Dollars. AECO trades almost exclusively in Canadian Dollars. Therefore Avista

Energy or the Utility, if the Mechanism were brought back, is exposed to the continuing risk of changes in the exchange rate between US currency and Canadian currency. The $176,000 in the table represents our estimate of that cost.

Finally, the $231,000 of load volatility cost represents the estimated share of the daily swing around the average that Avista Energy is exposed to, i.e. it represents Avista Energy's 20% exposure to the load swings.

**Q. How is the proposed management fee different than the five cent adder?**

A. When the original Benchmark was first established in 1999 the pricing structure was set up as First Of the Month index (FOM) plus an adder for all natural gas acquired to serve Avista Utilities' load. The adder was set at 5 cents per Dekatherm on all volumes. This adder was established as a surrogate for the amount above index that the Utility had been able to purchase gas for historically, given the low annual load factor inherent with temperature sensitive core demands. In essence it was an annual load factor premium. Since that time many things have occurred in the market that have changed the way we purchase gas for Utility loads. Because of the extreme price volatility that we experienced in 2000/2001 we found it necessary to hedge or "fix" prices on a portion of the customers load to provide price stability. Also, because of the price volatility and other factors, credit and counterparty risk have become significant cost issues for the Utility and its customers. The 5 cent adder paid to Avista Energy has become more of a management fee to protect customers from price volatility, risk inherent with load swings due to weather, and to insulate customers from other risks like credit and counter party risk. We are proposing a restructuring of the "adder" to a management fee that is not volume based.

Avista Utilities is proposing to pay $900,000 annually to Avista Energy as a management fee to cover the costs and risks identified earlier. In addition, Avista Energy has a performance based incentive opportunity through the 80%/20% symmetrical sharing incentives. As Avista Energy captures value, 80% goes to utility customers and 20% to Avista Energy.

Additional details related to the increase in costs to customers if the gas procurement operations were moved back in the utility are provided in workpapers accompanying this filing.

## IV. COMPONENTS OF THE BENCHMARK MECHANISM

**Q. To put the components of the program in perspective, what is the total annual gas cost under the program and what portion does each of the three components represent?**

A. Please refer to page 1 of Mr. Norwood's Exhibit _____(KON-2). This slide identifies the total annual cost of gas and the relative proportions of the three components. The data represented on this slide is the relationship of costs experienced by Utility customers for the period from April 1, 2002 through March 31, 2003. The total gas costs for the period are $76.3 million. The Commodity Component represents about 76.2% of the total, Storage represents about 6% and Transportation represents about 17.8% of the total annual cost. The cost of storage represents the cost of gas cycled through storage on an annual basis and is net of seasonal savings to customers. The cost of Transportation is likewise net of benefits provided by Avista Energy. In this portion of my testimony I will

explain each of the components of the proposed Mechanism followed by a brief explanation of how each component is different than the current Mechanism.

**A. Commodity Component**

**Q. Please explain the Commodity Component of the proposed Mechanism.**

A. As shown at page 2 of Exhibit_____(RHG-2) the Commodity component represents $58 million or approximately 76.2% of the cost under the proposed Mechanism. Acquisition and pricing for commodity is set up in tiers. Some of the tiers have been modified from our original proposal. Those changes will be discussed below. To determine the structure of the individual tiers, the average customer load is projected for each month as well as the maximum and minimum loads.

Tier 1 is designed to approximate the minimum load one would see in any month. This minimum load is satisfied using a combination of fixed price gas purchases and base load storage, which are both essentially fixed price products. This first tier represents approximately 50% of average daily core load each month. Tier 1 is illustrated in the chart on Page 3 of Exhibit_____ (RHG-2) as the first layer of supply to serve our customers' average load each month.

While the fixed price base in Tier 1 provides price stability to customers, it does not always provide the lowest cost. In order to provide the best fixed price benefit to customers we spread the acquisition of fixed price products out over the season generally between mid-February and mid-November.

**Q. Who makes the decisions with respect to when and at what price to enter into deals for fixed price products or hedges?**

A. The Utility and Avista Energy have a joint Strategic Oversight Group that meets periodically to set targets for execution of hedge products for future purchase. The Group reviews a number of things that result in market impacts on the forward price of gas, including seasonal nationwide storage refill levels, regional pipeline expansion projects, long term weather forecasts, the world price of oil, and forward price contracts on the New York Mercantile Exchange. Avista Energy executes the fixed price transactions in Tier 1 following the guidelines set by the Strategic Oversight Group.

**Q. Please continue with your discussion of the Commodity Components.**

A. As shown on page 3 of Exhibit_____ (RHG-2), Tier 2 in the proposed Mechanism is a fixed volume equal to the remaining 50% of the average customer load each month. The pricing for all gas in Tier 2 is based on the first of the month (FOM) index.

In summarizing Tier 1 and Tier 2, the fixed price purchases in Tier 1, plus Jackson Prairie storage withdrawals, plus Tier 2 FOM purchases will always equal the estimated average customer load each month. That is, prior to entering each month, purchases have already been made, representing the total of Tier 1, Tier 2, plus planned storage withdrawals that are equal to the estimated average load for the upcoming month.

As we enter the month, to the extent that the daily load within the month is different than the previously estimated average load, daily purchases or sales (Tier 3) are made as necessary to balance actual total supply with actual total load. Because Tier 3 covers only the daily load variations from the estimated average load, it represents approximately plus or minus 8% of the total annual load for Avista Utilities' customers.

The pricing for these daily purchases and sales will be equal to Avista Energy's actual average purchase cost or average sales price, as appropriate, for the respective day at each supply basins. In the event there are no transactions at the specific Basin, the Gas Daily published Daily index for that basin will set the daily price. Therefore, all daily purchase volumes will be delivered to the Utility at Avista Energy's actual average purchase cost for the day. All daily sales volumes will be sold on behalf of the Utility at Avista Energy's actual average sales price for the day.

In Tier 3, customers and Avista Energy share the gains or losses associated with daily purchases and sales, as compared to the initial purchases at FOM index, on an 80% customer and 20% Avista Energy basis. The gains or losses are calculated as the difference between the FOM index set in Tier 2 and the actual daily pricing experienced in Tier 3, times the respective Tier 3 sales or purchase volume.

Additionally, Storage can be used to substitute for daily purchases or sales in Tier 3. The decision to use storage will be based on current day pricing, and the estimated cost to replace storage at a future time. Other factors around the decision to use storage for Tier 3 replacement include an analysis of the deliverability decline from Jackson Prairie and the need to have deliverability to cover peak day demands. Avista Energy will consult with the Utility on storage for Tier 3 replacement but it will be the Utility's decision. More information on the Jackson Prairie deliverability issue will be provided later in this testimony. The use of storage for Tier 3 replacement will adjust a future period withdrawal level in the synthetic storage withdrawal schedule.

**Q. Please describe what is shown on page 3 of Exhibit RHG-2**

A. Each of the Tiers is illustrated on Page 3 of Exhibit_____ (RHG-2). The individual months are shown in bar graph format with the Tiers clearly identified. The graph shows the average monthly load as the heavy black line. The Tier 1 fixed price component and the scheduled storage withdrawals are the first layers as indicated on the graph. The difference between Tier 1 and the intersect of the average monthly load represents the Tier 2 volume for the month. Tier 3, as explained earlier, is the daily variation of load from the originally estimated average load for the month. To the extent the actual daily load is different than the planned load, the volume difference is either sold or purchased at the daily pricing described earlier.

**Q. Under the proposed Mechanism will supplies continue to be purchased from the three supply basins similar to the Mechanism currently in place?**

A. Yes. Natural gas supplies for Avista Utilities are acquired from three supply basins: AECO (Alberta), Sumas (British Columbia) and the Rockies (Domestic) supply basins. The Commodity component will continue to be priced based on weighted average purchases and/or prices from these basins. This will include Tier 1 fixed price purchases, injections for storage, Tier 2 FOM index purchases, and Tier 3 daily purchases and sales.

The percentages assigned to each of the basins are designed to be representative of the supplies and transportation available to the Utility from each supply basin. Please refer to page 4 of Exhibit___ (RHG-2). This slide indicates the amount of deliverable transportation capacity from each basin. The basin weightings are set in January and are effective for the 12 month period that begins the next November 1st to cover the following heating season and

are adjusted each year. The basin weighted average cost of gas for 2003/2004 is set at 57% AECO, 25% Rockies and 18% Sumas.

**Q. Has the Company addressed the issue raised by Commission Staff regarding the capture of additional value between the three supply basins?**

A. Yes. Because the Basin Weightings are set based on peak day availability, there are many days when the percentage of actual purchases and transportation from the lowest cost basin can be increased. This provides additional opportunity to capture benefits from the price differential between supply basins that is not already captured through the supply basin percentage weightings. I will refer to this as "Basin Optimization."

Under the current Mechanism, Avista Energy retains the Basin Optimization benefits to offset the risks associated with covering load swings within Tier 2 FOM index pricing. As part of the proposed Mechanism, the cost of covering the load swings and the benefits of Basin Optimization would be shared between customers and Avista Energy on an 80%/20% basis.

The Basin Optimization component impacts both the Commodity and the Transportation components of the proposed Mechanism. Avista Energy will optimize this Basin Weighting opportunity and share the benefits on an 80%/20% basis with customers.

**Q. In summary, how is the Commodity Component proposed in this filing different than the Mechanism that is currently in place?**

A. While the basic commodity structure of the Benchmark is similar to the structure that is currently in place a number of changes have been proposed.

The structure currently in place includes fixed pricing and a synthetic storage component in Tier 1. This tier provides price stability to customers. Very few changes are being proposed for Tier 1. Most of the changes to the Commodity Component have been incorporated into Tiers 2 and 3.

The structure of Tier 2 that is currently in place includes a band or range of consumption for each month that covers most of the load swings due to weather related changes. In contrast, the proposed Tier 2 is a single point in the demand curve that represents the average core customer demand for each month.

The current Mechanism also has Tier 3 and Tier 4 components, which represent only the most extreme load swings and are priced at Gas Daily. Tier 4 currently has the flexibility to utilize storage to offset high day costs. Tiers 3 and 4 have been combined into a single Tier 3 under the proposed mechanism. Under the proposal, all of the load swings occur in Tier 3. As stated above, daily pricing under Tier 3 can be offset with storage withdrawals.

The other primary change is that we have introduced, in the form of an incentive, a symmetrical risk reward component to the Commodity structure in Tier 3 where the customers share in the gains and losses above and below the Tier 2 purchases (or average monthly load).

**Q. Are the various Tiers of the Commodity Component and the transactions in the Basin Optimization component auditable?**

A. Yes. Tiers 1 and 2 are auditable on a transaction specific basis. Tier 3 purchases will be priced at the actual average price of Avista Energy's purchases or sales for each given day for the respective supply basins. In the event there are no transactions at the specific

Basin the Gas Daily published Daily index for that basin will be used. These purchases and sales are auditable because the volumes above or below average for customer load is determinable. A comparison of actual purchases or sales by Avista Energy is available and therefore an average price can be determined. The transactions for Forward Basin Optimization are also auditable on a transaction specific basis.

**B. Storage Component**

**Q. Please continue with an explanation of the Storage Component of the Benchmark Mechanism.**

A. As shown on page 3 of Exhibit_____(RHG-2), the Storage component represents approximately 10% of the annual supply for Utility core load. Under the proposed Mechanism, customers will share in the seasonal benefit of a 100% cycle in the storage project with the gas purchased at FOM in the summer and withdrawn in the winter months to offset the higher cost of winter supplies. The purchases and withdrawals are made on a relatively structured basis to assure that a 100% cycle is achieved. The purpose of storage is not only to provide the benefits of the winter/summer price differential but also to provide reliability of peak day demand coverage for utility customers.

Because the daily availability of withdrawals from Jackson Prairie storage declines with the decline in pressure in the field as gas is withdrawn, it is necessary to keep a fairly large portion of the inventory in the project through most of the heating season to provide the peak day deliverability intact. Under the proposed Mechanism, we have incorporated a considerable amount of flexibility in storage withdrawals. This flexibility includes

reliability of peak day demand coverage for customers, covering load swings and offsetting more costly Tier 3 supplies at daily pricing, while still achieving the benefit of a 100% cycle summer/winter price differential.

Because of the deliverability declines referenced above, it is possible to withdraw too much gas too early in the season and render the storage facility ineffective in the ability to cover peak day demand. While the cost of the gas in the Storage Component represents only about 6% of the Utility's annual cost, approximately one-third of the Utility's core peak design day is satisfied from storage. Having storage as a reliable supply source is critically important to the Utility. The graph on page 6 of Exhibit____(RHG-2) shows the storage capability and daily delivery capability of the Jackson Prairie Storage Facility.

**Q. When the gas procurement services were managed within the Utility, did the Utility achieve a 100% cycle for Storage?**

A. No. Historically, the Utility was rarely able to cycle storage 100%. This was mainly due to reliability concerns by the Utility. The deliverability decline begins when there is less than 60% inventory remaining in storage. The Utility generally targeted keeping a 60% inventory level in storage for full deliverability through the middle of February each year. Withdrawal of storage in the spring against a typically declining market price usually resulted in either withdrawing storage to replace less expensive purchases or not achieving a full cycle each year.

**Q. How is the Storage Component proposed in this filing different than the Mechanism that is currently in place.**

A. Please refer to page 5 of Exhibit____ (RHG-2). As reflected in the slide, the cost of gas cycled through storage each year is approximately $4.5 million or 6% of the total cost of gas. The Storage component is still set at a 100% cycle each year with purchases in the summer and withdrawals in the winter period. The primary cost saving benefit for customers from storage is the ability to capture the summer/winter price differential. An incentive has been added to storage to encourage the capture of market variances. The synthetic schedule for injections and withdrawals will remain as an aggregate benchmark. Avista Energy will have the flexibility to inject earlier or later than the synthetic schedule as long as the operating tariff schedule for the Jackson Prairie Storage facility is met. If the actual weighted average cost at the end of the injection season is above or below the aggregate benchmark WACOG set by the synthetic injection schedule at FOM, the customers will share 80/20, thereby enjoying 80% of the savings and being protected from 20% of the losses that may have occurred. Likewise, if other storage opportunities occur that are consistent with the injection contract requirements and the need for reliability of peak day deliverablitiy, the customers will share 80/20.

**Q. Is the Storage Component auditable?**

A. Yes, the cost components are straightforward as they are based on First of Month index pricing. The new injection flexibility which includes the sharing component is auditable because purchases outside the synthetic schedule will be priced at the average price of all of Avista Energy's purchases for each given day. These purchases are auditable because the volumes above or below average for the synthetic schedule are determinable. A

comparison of actual purchases or sales by Avista Energy is available and therefore an average price can be determined.

**C. Transportation Component**

**Q. Please explain the Transportation Component of the Proposed Benchmark Mechanism.**

A. Continuing with a discussion of the components at page 7 of Exhibit____(RHG-2) the Transportation component represents $13.6 million or approximately 17.8% of the Utility's annual cost. This component is designed to provide an incentive to Avista Energy to achieve maximum optimization of the Company's transportation assets. This component is sometimes referred to as "Capacity Release/Off-System Sales" because those are the two primary tools utilized in managing this asset. Avista Energy optimizes the Company's underutilized transportation capacity either by making capacity releases to third party replacement shippers, or by using the capacity to move gas to others in the form of off-system sales. The customers get the benefit of capacity releases through credits received from the pipeline in the form of a reduction in transportation expense. Off-system sales are credited to the customers by calculating the difference in daily index pricing between the receipt point of the gas and the delivery point of the gas. Under the proposed Mechanism, Avista Energy guarantees that the customers will receive 100% of the credit up to $3 Million per year, with an 80%/20% sharing mechanism for all dollars beyond $3 million.

**Q. Please contrast these changes with the existing Transportation Component of the Benchmark Mechanism.**

A. Under the current Mechanism, the customers get 100% of the benefit of the Transportation component up to $5 million, but there is no guarantee that they will reach that level. Beyond the $5 million goal, the Customers and Avista Energy share on a 50/50 basis. The proposed mechanism provides a guarantee of $3 million with 80/20 sharing thereafter.

**Q. Is the Transportation Component in the Proposed Mechanism auditable?**

A. Yes. The benefits received from the Transportation component are transaction specific. That is, each capacity release can be clearly tracked on the Pipeline's electronic bulletin board. Each-off system sale where the Utility's pipeline transportation is used also gets a separate confirmation listed on the pipeline's monthly invoice. Therefore all of the transactions and the benefits are auditable.

**Q. Would there be a change in the administrative costs to Avista Utilities associated with the proposed Mechanism?**

A. Yes. Implementation of the Mechanism and Agency Agreement in 1999 originally allowed Avista Utilities to reduce its administrative costs associated with natural gas procurement operations. These savings have been credited to Washington customers, through the PGA deferral process, at the fixed amount of $80,600 per year. In this filing the Company is requesting a reduction of this amount to $22,400. This reduction is required to account for a new Utility employee (loaded labor plus associated costs) required to track the proposed component changes. This amount would continue under the proposed tariff until these cost savings are reflected in rates through a future rate proceeding. This change is necessary because many of the changes proposed in this filing are transaction specific and therefore labor intensive. It is important for the Utility to be able to audit

activities at Avista Energy that relate to the Benchmark.

**Q. Would you please provide a summary of all of the modifications to the current Mechanism that are included in this filing?**

A. Yes. Page 8 of Exhibit_____ (RHG-2) is a table that provides a comparison of the various components of the Benchmark Mechanism: current vs. proposed.

These changes have been made to address issues raised by Staff regarding the current Mechanism. In Staff's memo recommending suspension of the current mechanism, Staff contended that the Utility's commodity costs would be lower if they had better access to the lowest cost basins. We have addressed this issue by making modifications to the Commodity component that results in a sharing of benefits from "Basin Optimization."

Staff also indicated concerns that there was no risk or reward with regard to storage, and that there was no revenue and risk sharing symmetry in the proposed mechanism. Staff also expressed concern that the only sharing was with the 50/50 sharing of capacity release/off system sales, and even with that part of the mechanism, they argued that there was no risk to Avista Energy because there was no guarantee of the $5 million. Each of these concerns has been addressed in our proposal.

**Q. Does this complete your pre-filed direct testimony?**

A. Yes it does.

BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

EXHIBIT NO. __ (RHG-2)

AVISTA Corp.

# Benefits provided to Avista Utility Customers:

- **Economies of Scale**
  - *Expertise
  - *Sophisticated tools
  - *Administrative cost savings
  - *Access to larger customer base
  - *Access to additional markets
- **Mitigation of Risk**
  - *Currency
  - *Credit and Banking
  - *Nomination Errors
  - *Gas Daily Volatility
  - *Counter Party
  - *Entitlement Risk
- **Storage**
  - *100% Cycle Guarantee
  - *Additional operational flexibility to use as a partial hedge during extreme cold weather events
- **Pipeline Optimization**
  - *Optimization of available capacity while preserving capacity to serve customer load
- **Total Annual Benefits** (Administrative, Other, Risks, Optimization: Savings & Benefits)
  - *Estimated customer benefits of at least $3.5 million annually

**Result = Lower costs to customers than would be possible under Avista Utilities' smaller scale natural gas procurement operations.**

Avista Energy - Management of Gas Procurement Services

# Proposed Benchmark Mechanism - Commodity

**Effective: Jan 30, 2004 - Mar 31, 2007**

## Total Cost Of Gas = $76.3*

Commodity

$58 m or 76.2%

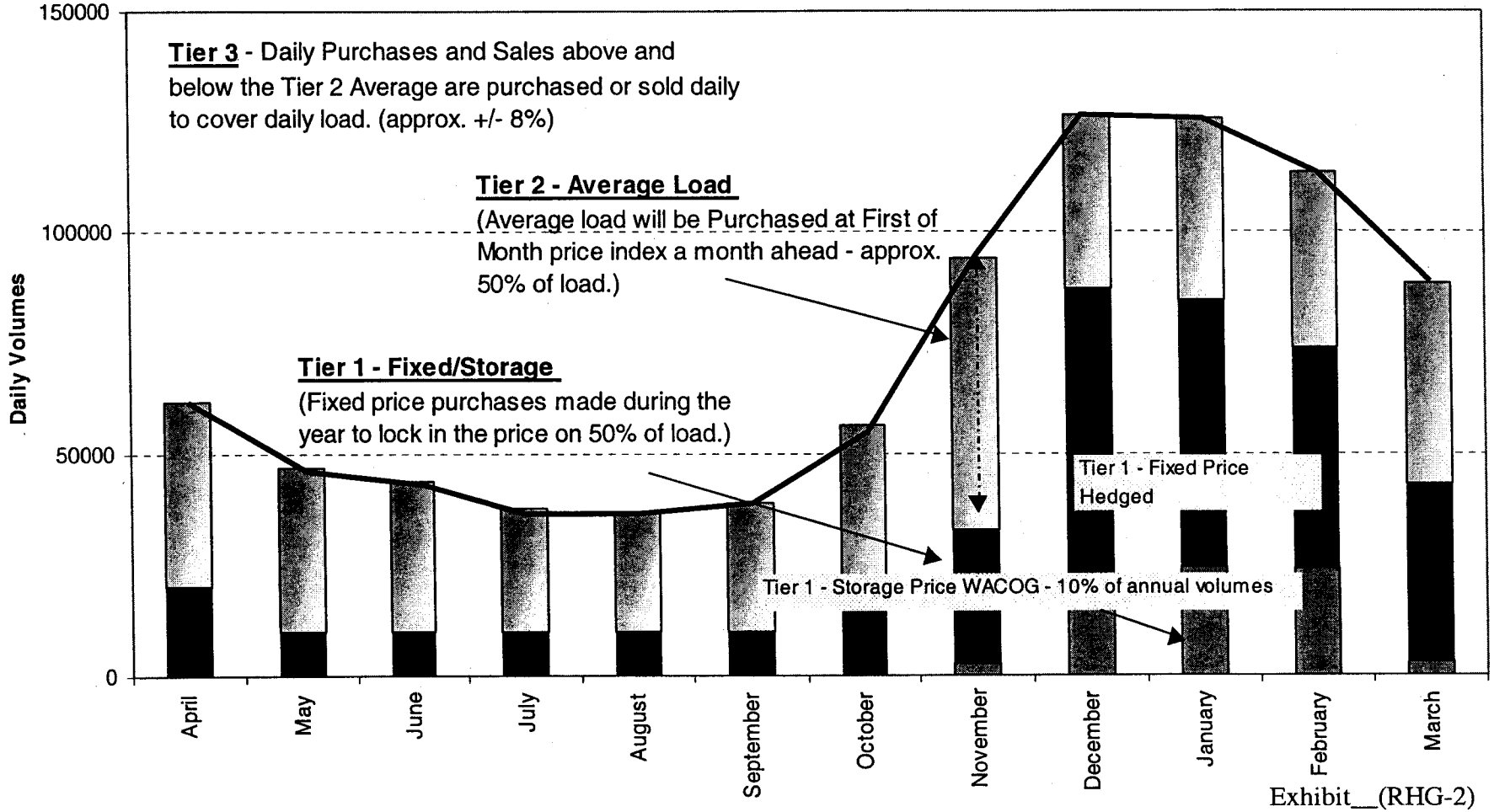
| | | | Auditable |
|---|---|---|---|
| Tier 1 | 50% | Fixed/Storage | Yes |
| Tier 2 | 50% | FOM (purchase to average load) | Yes |
| Tier 3 | +-8% | Daily balancing (daily sales or purchases to balance loads, at AE's average daily cost/revenue) | Yes |

**Incentive Built In:** YES - 80/20 - Sharing of basin optimization and loss/gain on Tier 3 daily balancing of loads.

*WA only for April 2002 - March 2003

AVISTA Corp.

# PROPOSED - Benchmark Mechanism
# Tiered Commodity Program - Tiers 1-3
# Effective: Jan 30, 2004 - Mar 31, 2007




Exhibit__(RHG-2)
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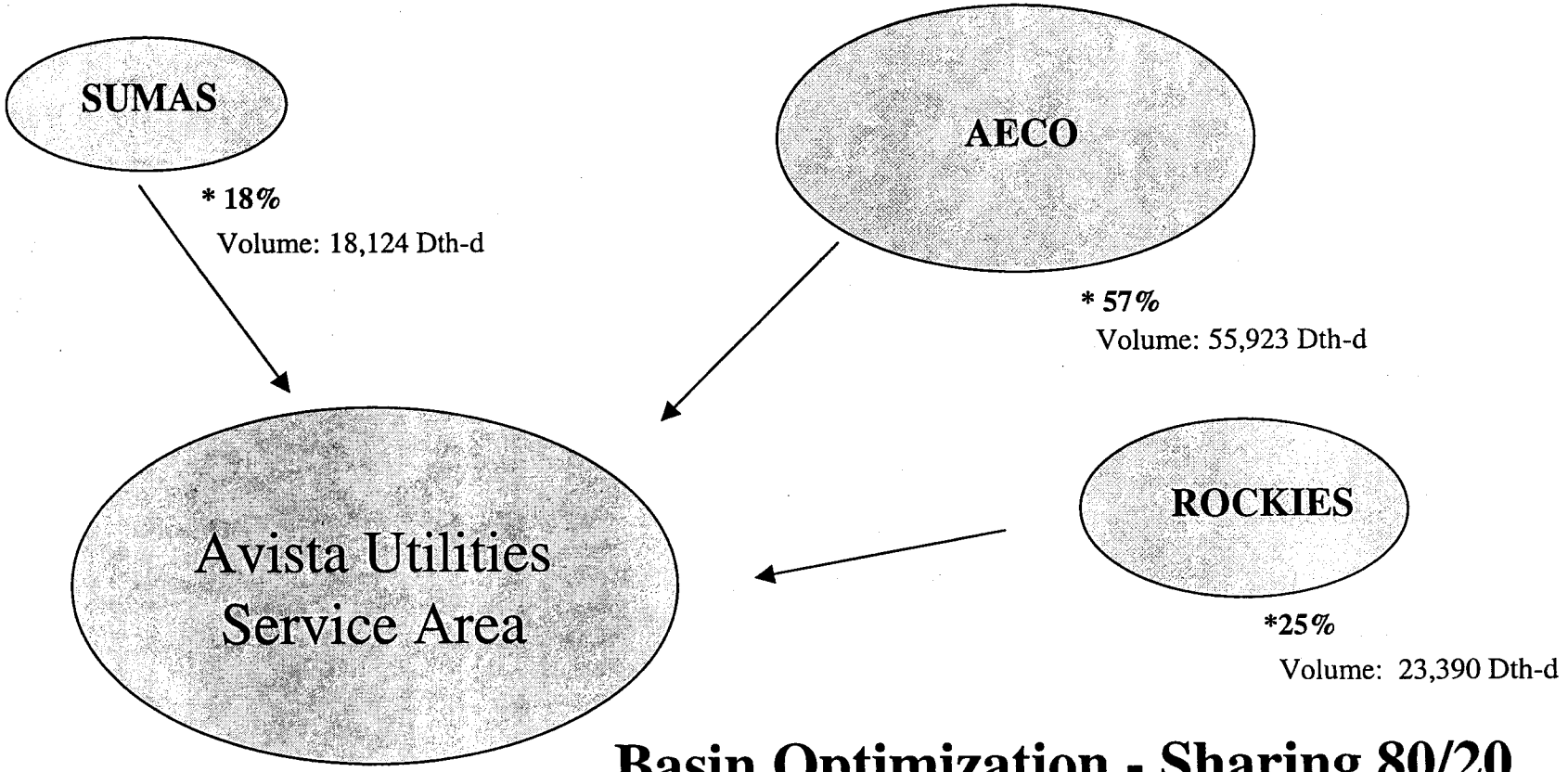
Avista Corp.

# Pipeline Transportation - allows Avista Utility to receive Commodity from three Supply Basins to serve System load




# Basin Optimization - Sharing 80/20

**Note:**
*** % Split between basins effective November 1, 2003.**
**- Maximum transportation allowed at Average day is 35% SUMAS, 32% ROCKIES, and 63% AECO.**

Avista Energy - Management of Gas Procurement Services

# Proposed Benchmark Mechanism - Storage

**Effective: Jan 30, 2004 - Mar 31, 2007**

## Total Cost Of Gas = $76.3m*

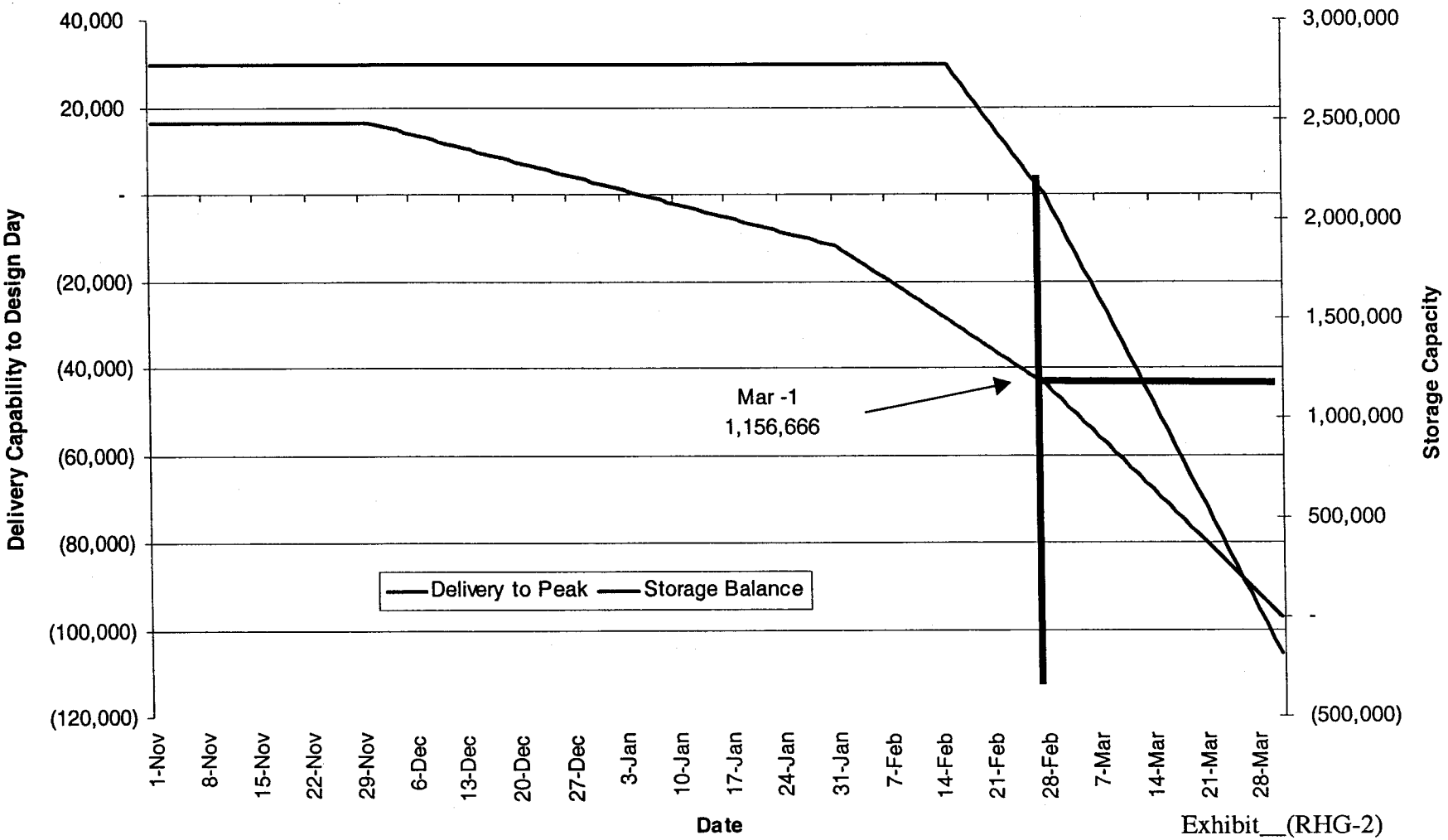
| Storage | | | Auditable |
|---|---|---|---|
| $4.5m or 6% | → | 100% Cycle<br>80/20 Sharing | Yes |

**Incentive Built in: Yes - Sharing 80/20 - Use of Storage during Tier 3 purchases and sales (when economically feasible and when reliability is not sacrificed) reduces the price risk paid by Avista Energy and customers.**

*WA only for April 2002 - March 2003

AVISTA Corp.

## Storage Capabilities/Decline Curve



Avista Energy - Management of Gas Procurement Services

# Proposed Benchmark Mechanism - Transportation

**Effective: Jan 30, 2004 - Mar 31, 2007**

## Total Cost Of Gas = $76.3m*

| | | | |
|---|---|---|---|
| Transportation<br>$13.6m or 17.8% | → | **$3m Guarantee**<br>**80/20 Sharing after** | **Auditable**<br>**Yes** |

**Incentive Built in: YES - Customers receive first $3m of benefit, and 80/20 sharing after.**

*WA only for April 2002 - March 2003

# Avista Utilities - WASHINGTON

## Comparison of Natural Gas Benchmark Mechanism: Current VS Proposed

| | Current Mechanism | | | Proposed Mechanism | | |
|---|---|---|---|---|---|---|
| **Commodity Component:** | | | | | | |
| | Natural Gas Supply Basins | | | Natural Gas Supply Basins | | |
| Weighting for Supply Basins | AECO | Sumas | Rockies | AECO | Sumas | Rockies |
| | 50% | 18% | 18% | 50% | 18% | 18% |
| | (14% float-determined annually | | | (14% float-determined annually | | |
| | Sumas/Rockies can max 25% each) | | | Sumas/Rockies can max 25% each) | | |
| **Sharing of Basin Optimization** | | NO -covered risk of loss on | | | **Yes 80%/20%** | |
| | | Tier 2 | | | | |
| Index Adder (Fixed) - $/Dekatherm / Fee | $0.05 | Adder on all dekatherms | | $ 900,000 | Management Fee | |
| Tiered Commodity Program: | | | | | | |
| (1) Long Term average usage hedged (JP included) | 50% | Fixed / Storage | | 50% | Fixed / Storage | |
| (2) First Of Month (FOM) index | 47.0% | FOM pricing | | 50.0% | FOM purchased to Average | |
| (3) Daily Purchases and Sales | 3.0% | Gas Daily Purchases and Sales | | +- 8% | Daily Purchases and Sales | |
| (4) Use of JP and Plymouth storage facilities - (Nov 20 - Feb 10) | 0.4% | Use of Storage | | N/A | (Plus use of Storage) | |
| Sharing of Gains and Losses - Commodity Component | | NO -AE obsorbed all losses | | | **Yes 80%/20%** | **(of daily swing** |
| | | around Tier 2 range | | | | **around the average)** |
| **JP Storage Component** | | | | | | |
| Synthetic Withdrawal Cycle | | Nov - Mar | | | Dec - Mar | |
| Injections | | May - Sept | | | May - Sept | |
| | | 100% Cycle | | | 100% cycle | |
| **Sharing of Storage gains and losses** | | NO - Customers 100% | | | **Yes 80%/20%** | |
| **Capacity Release/Off-System Sales Component** | | | | | | |
| Capacity Release and Off-System Sales Benchmark - Annual | | $ 5,000,000 | / yr | | **$ 3,000,000** | **/ yr** |
| - The Capacity Release/Off-System Sales Benchmark is guaranteed | | (not guaranteed) | | | **Guaranteed** | |
| to customers on an annual basis | | | | | | |
| Sharing of Cap Rel/Off-Syst Sales in excess of guarantee | | Yes 50%/50% | | | **Yes 80%/20%** | |
| **Credit for A&G Cost Savings** | | | | | | |
| A&G Cost Savings | | $80,600 annually for WA | | $22,400 annually for WA - (adjusted for new | | |
| | | | | Utility employee required to track components) | | |
| **Timeline** | | | | | | |
| | | Apr 1, 2002 - Jan 29, 2004 | | Jan 30, 2004 - Mar 31, 2007 | | |