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BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET NO. UG-021584

DIRECT TESTIMONY OF KELLY O. NORWOOD (KON-1T)

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

A. My name is Kelly O. Norwood. I am employed as Vice-President of Rates and Regulation 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 Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. I joined the Company in June 1981. Over the past 22 years I have spent approximately eleven years in the Rates Department with involvement in cost of service, rate design and revenue requirements. I have spent approximately eleven years in the Energy Resources Department (power supply and natural gas supply) in a variety of roles with involvement in resource planning, system operations, resource analysis, negotiation of power contracts, and risk management. I was appointed Vice-President of Rates and Regulation in November 2000.

Q. What is the scope of your testimony in this proceeding?

A. I will provide an overview of the proposed Benchmark Mechanism and the modifications that we are proposing to address concerns raised by Commission Staff. I will briefly explain the benefits of the Benchmark Mechanism to Avista Utilities' customers, the incentives that are built in to encourage Avista Energy to drive additional benefits for customers, as well as the auditability of the Benchmark Mechanism. Finally, I will also introduce each of the other witnesses sponsoring testimony on the Company's behalf.

1 **Q. Are you sponsoring any Exhibits with your testimony?**

2 A. Yes, I am sponsoring Exhibit No. ____ (KON-2) which was prepared under
3 my direction.

4 **Q. Would you please summarize the Company's request in this filing?**

5 A. Yes. Through this filing, the Company is requesting an order approving the
6 extension of the Natural Gas Benchmark Mechanism (Mechanism). The present
7 Mechanism, as ordered in Docket No. UG-021584, expires January 29, 2004. The
8 Company requests approval of the proposed accounting and ratemaking treatment, and
9 such other approvals as may be necessary related to the extension of the Mechanism. The
10 Company is proposing to continue the Mechanism with some refinements as explained
11 below, through the existing natural gas Tariff Schedule 163. The Company also requests
12 that the proposed Tariff Schedule 163 remain in effect for a three year and two month
13 period, until March 31, 2007.

14 **Q. Please explain which tariff schedules are before the Commission for**
15 **consideration at this time.**

16 A. On December 2, 2002, the Company filed proposed tariff revisions to modify
17 and extend the Mechanism. The operation of these proposed tariff revisions was suspended
18 by order of the Commission pending hearings. To accommodate the Company and the
19 hearing process in this docket, the Commission permitted Avista to change the expiration
20 date on the existing Mechanism tariff from March 31, 2003 to January 29, 2004.
21 Accordingly, Avista's current Mechanism remains in effect during the pendency of these
22 hearings.

1 In response to issues raised by Commission Staff at the time this matter was set for
2 hearing, Avista has submitted, as a preferred alternative, further tariff revisions to address
3 the specific concerns raised by Staff. These further revisions are discussed in the
4 Company's pre-filed testimony and are reflected in proposed revisions to Tariff Schedule
5 163, as further explained and sponsored by Avista witness Brian Hirschorn. While
6 approval by the Commission of either the tariffs suspended on January 29, 2003, or the
7 tariff revisions submitted with this April 21, 2003 filing is acceptable to the Company,
8 Avista has submitted the April 21, 2003 tariff revisions as the preferred alternative, in that
9 the revisions directly address the recent concerns raised by Staff.

10 11 **II SUMMARY OF PROPOSED MECHANISM**

12 **Q. Would you please describe the Proposed Mechanism?**

13 A. Yes. As further discussed in Witness Gruber's testimony, there are three
14 major components of the Mechanism. First, is the Commodity Component in which gas
15 volumes are purchased under a diversified portfolio approach that we believe provides an
16 appropriate balance of lowest cost supply and price stability over time. Second, is the
17 Jackson Prairie (JP) Storage Component, which provides benefits to customers from the
18 operation of the JP Storage Project. Third, is the Capacity Release and Off-System Sales
19 component, which provides benefits to customers from the optimization of all pipeline
20 capacity reserved for the utility's customers.

21 The Mechanism includes symmetrical sharing incentives in which risks and
22 rewards are shared between Avista Utilities' customers and Avista Energy by incorporating

1 a risk of loss from poor performance as well as opportunities for rewards from good
2 performance.

3 The Mechanism provides an objective determination of the gas costs to be charged
4 to customers, additional gas cost savings to customers compared to what the Utility could
5 achieve, and a shift of risk and costs to Avista Energy associated with gas procurement and
6 management. Through the existing Mechanism, these risks and costs, such as market
7 liquidity, counter party risk, management of intra-month load and price volatility, and
8 credit risk are borne by Avista Energy. In addition, the Mechanism is broad in focus,
9 working to optimize all of the assets of the Company with the goal of providing the
10 maximum benefit to customers while ensuring reliability, reducing the effects of potential
11 price volatility and minimizing risk.

12 The Mechanism works in conjunction with the existing Purchased Gas Adjustment
13 (PGA), Tariff Schedules 150 and 156. Deferrals for the PGA are calculated each month
14 based on the costs and revenues from the Mechanism components, as well as other costs
15 normally included in the PGA.

16 As shown on page 1 of Exhibit__(KON-2), and discussed further by Witness
17 Gruber, total gas costs for the period 4/1/02-3/31/03 totaled \$76.3 million and can be
18 broken down as follows:

- 19 (1) Commodity Costs (approx. 76.2%),
- 20 (2) Storage Costs (approx. 6%) and
- 21 (3) Transportation Costs (approx. 17.8%).

22 **Q. In light of Staff's recent comments as this Mechanism was set for**
23 **hearing, please describe what you've done to address their concerns.**

1 A. As discussed in detail in Mr. Gruber's testimony, changes are being
2 proposed in this filing to address specific concerns raised by Staff. An overview of the
3 more significant changes proposed are as follows:

4 1.) **Basin Optimization:** The Mechanism has been modified so that Utility
5 customers will receive additional benefits from the price differential
6 between supply basins that are not already captured through the supply basin
7 percentage weightings that are selected by Avista Utilities.

8 2.) **Greater Use of Storage to Cover Daily Load Variations:** We are
9 proposing modifications that will provide greater use of JP Storage to cover
10 daily load variations. To the extent that it does not jeopardize reliability of
11 supply, customers will receive the benefits and risks associated with
12 additional injections and withdrawals of storage to cover daily load
13 variations.

14 3.) **Symmetrical Sharing Incentives:** All components of the Mechanism
15 provide for a sharing of risks and rewards on the basis of 80% to customers
16 and 20% to Avista Energy.

17 4.) **Auditability:** Modifications have been made so that all components of the
18 Mechanism are fully auditable by Avista Utilities and Staff.

19 We believe that these proposed modifications fully address the major concerns
20 raised by Commission Staff in the recent Benchmark approval process.

21 Q. Would you please provide a brief history of the Mechanism, and the
22 refinements that have been made over time?

1 A. Yes. In Washington, the Benchmark was originally implemented in
2 September 1999, in Docket No. UG-990614, for a two-year and seven month period ending
3 March 31, 2002. On November 7, 2001, the Company filed a petition requesting extension
4 of the Mechanism until March 31, 2005. The Commission approved a one-year extension
5 of the Mechanism in Docket No. UG-011500, through March 31, 2002. This extension
6 included modifications to the Mechanism that incorporated among other things, a gas
7 procurement hedging strategy (Tiered Commodity Program) that the Company believed
8 would reduce the level of gas cost volatility and risk under the original Mechanism while
9 continuing to provide customers with a reliable supply of natural gas.

10 On November 29, 2002, the Company filed a request for extension of the
11 Mechanism which included some additional minor changes to the Mechanism that
12 provided additional flexibility on behalf of Avista Utilities and its customers in the way the
13 Mechanism is managed by Avista Energy, such as use of Storage in Tier 3 to help reduce
14 daily gas prices and more flexibility in the Company's hedging and Storage synthetic cycle
15 schedules. In addition changes were recommended to increase the auditability of the
16 Mechanism. However, this latest petition on November 29, 2002 was suspended, and the
17 existing Tariff Schedule 163 was extended for an additional year until January 29, 2004
18 through the Commission order in this Docket dated January 29, 2003.

19 The additional changes proposed in this filing are a continuation of the Company's
20 efforts to improve the Mechanism, and to have an incentive Mechanism in place that
21 provides meaningful benefits to our customers.

22 **Q. What is the status of the Mechanism in the other jurisdictions in which**
23 **Avista Utilities provides natural gas service?**

1 A. Idaho and Oregon approved a mechanism similar to the current Washington
2 Mechanism in the first quarter of 2002, extending each jurisdiction's Mechanism until
3 March 31, 2005. It is administratively efficient and cost effective to continue this
4 Mechanism in all three jurisdictions, including Washington. To bring all of the gas
5 procurement functions back inside the Utility to serve the needs of one of three
6 jurisdictions could prove cumbersome and inefficient.

7
8 **III. BENEFITS OF BENCHMARK MECHANISM**
9 **UNDER AVISTA ENERGY**

10 **Q. Could you please describe how Avista Energy's management of the**
11 **Mechanism benefits the Utilities' customers?**

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

21
22 As an example, Avista Energy engages in more active management of Off-System
23 sales, which has provided greater monetary benefits to customers than could be realized
24 under a smaller-scale utility operation. Activities under this portion of the Mechanism have

1 proven to be very beneficial to customers. Volatile market conditions with wide price
2 disparities between receipt and delivery points of transport have enabled Avista Energy to
3 optimize Off-System sales. Through the management of unutilized capacity within the
4 Mechanism, Avista Utilities receives the market value of the capacity (the market price
5 difference between basins), while generally, the maximum that could be received through
6 Capacity Release for the Utility is capped at the maximum pipeline tariff rate. Through
7 analysis by the Utility of the Capacity Release and Off-System sales, it is estimated that
8 customers received approximately \$2 million of additional benefits annually than the
9 Utility would have achieved because of a lower Utility risk tolerance.

10 Under the current Utility risk policy, the Utility is focused only on transactions to
11 balance load and optimize resources. If the Utility were to engage in these riskier
12 transactions, the Utility's current credit cost would increase substantially, all other things
13 being equal. This additional cost is borne by Avista Energy under the Mechanism.

14 Page 2 of Exhibit__(KON-2) provides an overview of the corporate relationship of
15 Avista Utilities and Avista Energy, and lists the major functions of each entity as it relates
16 to providing gas resource management and supply to the Utilities' customers and the
17 benefits Avista Energy provides Utility customers through their gas procurement services.
18 Under the Mechanism, the Utility continues to provide gas services such as oversight of the
19 Mechanism for the benefit of customers, resource accounting, metering and the provision
20 of metered data and load forecasts for core customers to Avista Energy. The Utility is also
21 responsible for long term planning and maintaining pipeline assets in the form of
22 transportation contracts on the various pipelines that serve the Utility. The execution and
23 management of natural gas procurement is provided by Avista Energy.

1 **Q. Are there additional risks which are currently absorbed by Avista**
2 **Energy due to their management of the Mechanism?**

3 A. Yes. Consolidation of gas procurement operations under Avista Energy has
4 shifted many of the costs and risks associated with gas procurement operations from the
5 Utility and its customers to Avista Energy. Because of changes in the market, costs and
6 risks to Avista Energy associated with management of gas procurement for the Utility have
7 increased significantly since the original Mechanism implemented in 1999. Some of these
8 risks and costs include market liquidity, management of intra-month-price volatility,
9 currency and credit risks, and risk of non-payment by counter parties. As discussed further
10 by Mr. Gruber, under the proposed Mechanism the Utility conservatively estimates the
11 costs associated with these factors to total approximately \$1.5 million if the Mechanism
12 were within the Utility. In addition, as I explained earlier, we believe Avista Energy
13 provides additional value through management of available pipeline transportation of
14 approximately \$2 million per year. Therefore, the value to Avista Utilities' customers from
15 Avista Energy managing the procurement operations is estimated at approximately \$3.5
16 million annually.

17 The Company is proposing to eliminate the 5 cents per dekatherm adder in the
18 current Mechanism, and replace it with a \$900,000 per year management fee. The purpose
19 of the management fee is to cover a portion of the risks and costs being borne by Avista
20 Energy. On a net basis, we believe that our customers will realize benefits of
21 approximately \$2.6 million annually through the proposed Mechanism, as explained in
22 more detail by Mr. Gruber.

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1 **IV. SYMMETRICAL SHARING INCENTIVES**

2
3 **Q. Has the Company designed the Mechanism to include incentives to**
4 **cause Avista Energy to make decisions that benefit Utility customers, and to drive**
5 **additional value for customers?**

6 **A. Yes.** In order to address concerns raised by Staff, changes are being
7 proposed to the Mechanism in this filing to provide symmetrical sharing incentives for all
8 components within the Mechanism.

9 In order to share in the total risks and rewards around all components of the
10 Mechanism, the following sharing is being proposed: **80% customers / 20% Avista**
11 **Energy:**

12 **Commodity:**

- 13 a. Basin Optimization of Rockies, Sumas and AECO. The
14 Mechanism has been modified so that Utility customers will
15 receive additional benefits from the price differential between
16 supply basins that are not already captured through the supply
17 basin percentage weightings that are selected by Avista Utilities.
18 The value from this Basin Optimization will be shared 80% to
19 customers and 20% to Avista Energy.
- 20 b. The difference between daily prices and first of the month prices
21 for the daily customer load that deviates from the monthly
22 estimates will be shared 80%/20%.
- 23
24

1 **Storage:**

- 2 a. Gains/Losses from injections and withdrawals used to cover daily
- 3 load variability will be shared 80%/20%.
- 4 b. Gains and losses associated with the summer and winter price
- 5 differential will be shared 80%/20%.

6 **Transportation:**

- 7 a. Customers will receive 100% of a \$3 million guarantee related to
- 8 Capacity Releases and Off-System Sales.
- 9 b. Value above the \$3 million guarantee will be shared 80%/20%.

10 By building in symmetrical sharing incentives equally across all of the components,

11 i.e., 80%/20% sharing on each component, it encourages Avista Energy to drive value from

12 each component, and not favor one over the other. Additional details regarding these

13 incentives and how they work, are provided by Mr. Gruber.

14 **Q. Does the Proposed Mechanism comply with the Commission's Policy**

15 **Statement on Purchased Gas Adjustment Mechanisms?**

16 A. Yes. The Commission's Policy Statement, from Docket No. UG-940778

17 dated May 16, 1997, was created to provide local distribution companies (LDCs) with 15

18 guiding principles for the development and implementation of purchased gas adjustment

19 incentive mechanisms. As stated in Policy item #10, "The Commission should avoid

20 establishing a one-size-fits-all incentive mechanism. Each LDC should be allowed to file

21 an incentive mechanism that conforms with these policies, and meets the Company's

22 specific needs."

1 The Company believes that Avista's proposed incentive Mechanism conforms to
2 the spirit and intent of the Commission issued Policy Statement, as well as its guiding
3 principles and meets the specific needs of the Company.

4 5 **V. AUDITABILITY OF COSTS**

6 **Q. Has the Company proposed additional modifications to the Mechanism**
7 **to address Staff's concerns around the auditability of actual gas costs?**

8 A. Yes. Under the current and proposed Mechanism, Storage and
9 Transportation costs are transaction specific and are easily tagged and auditable as
10 belonging to the Utility. The proposed Mechanism includes some changes to the
11 Commodity Component that will allow Avista Utilities and Staff to audit the actual costs.

12 The Commodity component is made up of:

- 13 1) Tier 1 – Fixed Price Purchases are made during the year to lock in the price on
14 gas supply which, together with JP storage withdrawals, equals approximately
15 50% of the Utility's average load. The specific transactions are tagged by
16 Avista Energy for the Utility and are directly auditable.
- 17 2) Tier 2 – The remaining 50% of Avista Utility's average load is purchased in
18 advance at first of the month (FOM) index prices. These transactions will also
19 be tagged and auditable by the Utility.
- 20 3) Tier 3 – Natural gas is also bought and sold on a daily basis to balance supply
21 with load. Avista Energy balances the Avista Utilities' daily load together with
22 its entire system of client loads. The pricing to Avista Utilities for this daily
23 balancing will be the average actual daily price of all Avista Energy gas daily

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1 purchases on each given day, which Avista Utilities will be able to audit. In
2 addition, a comparison of this price can be made against the Gas Daily market
3 index price to insure it is representative of the daily market price to serve this
4 daily load variability. If Avista Energy does not actually purchase any gas
5 transactions on a given day, because they can cover the Utility load with
6 additional gas they have within their own portfolio, the price of the volumes
7 required by the Utility will be priced at the Gas Daily index for that day. These
8 daily volumes are expected to be approximately + or - 8% of total volumes
9 around the average. It is important to note that if natural gas procurement
10 operations were conducted within the Utility instead of Avista Energy, for this
11 relatively small daily balancing component, Avista Utilities would experience a
12 cost very similar to that provided by Avista Energy, i.e., a price representative
13 of the daily market price for natural gas.

14 Therefore, the changes proposed in this filing result in a significant improvement in
15 the opportunity to audit all revenues and expenses under the Mechanism.

16 **Q. Please summarize your testimony.**

17 A. Based on market conditions including price volatility, risks inherent within
18 the Utility's load volatility, and the expertise available through Avista Energy's
19 management of gas procurement services for the Utility, the Company believes that there
20 are additional benefits and cost savings provided to customers by Avista Energy compared
21 to what the Utility could achieve.

22 The proposed Mechanism provides symmetrical sharing incentives that will cause
23 Avista Energy to make decisions that will benefit Avista Utilities' customers, and drive

1 additional value for customers. Changes to the Mechanism have also been proposed such
2 that the Mechanism is fully auditable and in compliance with the Commission's Policy
3 Statement.

4 The following table summarizes the proposed Mechanism:

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

5
6 The Company requests that the Commission approve the proposed Mechanism for a
7 three year and two month period ending March 31, 2007. If however, it is decided by this
8 Commission that the Mechanism should not continue, the Company requests a 90-day

1 transition period to make other arrangements for the natural gas purchasing and
2 management functions.

3
4 **VI. OTHER COMPANY WITNESSES**

5 **Q. Would you please provide a brief summary of the testimony of the other**
6 **witnesses representing Avista in this proceeding?**

7 A. Yes. In addition to myself, the following witnesses are presenting direct
8 testimony on behalf of Avista.

9 Mr. Bob Gruber, Avista Utilities, Manager Natural Gas Resources, will provide a
10 more detailed explanation of the proposed Mechanism and changes that have been made in
11 order to address Staff's concerns. He will also discuss the benefits provided by Avista
12 Energy and why the Mechanism is important to the Utility and its customers.

13 Mr. Mike D'Arienzo, Avista Energy, Vice President-Gas Marketing and Trading,
14 will explain Avista Energy's role in managing the natural gas procurement operations for
15 the Utility, and will address the benefits that Avista Energy provides for the Utility's
16 customers.

17 Mr. Brian Hirschkom, Avista Utilities, Manager-Retail Pricing, will address the
18 accounting for the Natural Gas Benchmark Mechanism. In addition, he sponsors the
19 proposed and suspended Tariff Schedules 163 "Natural Gas Benchmark Mechanism."

20 **Q. Does that conclude your pre-filed direct testimony?**

21 A. Yes it does.

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8 **BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION**
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10 **DOCKET NO. UG-021584**
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12 **EXHIBIT NO. __ (KON-2)**
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Avista Energy - Management of Gas Procurement Services

Proposed Benchmark Mechanism - Overview

Effective: Jan 30, 2004 - Mar 31, 2007

Total Cost Of Gas = \$76.3m*

Commodity 76.2%
\$58 m

Tier 1 50% Fixed/Storage

Tier 2 50% FOM (purchase to average load)

Tier 3 +/-8% Daily balancing (daily sales or purchases to balance loads, at AE's average daily cost/revenue)

80/20 sharing on Tier 3

Storage 6%
\$4.5 m

100% Cycle
80/20 Sharing

Transportation 17.8%
\$13.6 m

\$3m Guarantee
80/20 Sharing after

Basin Optimization 80/20 Sharing

*WA only for April 2002 - March 2003

