

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-17\_\_\_\_\_

EXH. JDM-2

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## NATURAL GAS COST OF SERVICE STUDY

1  
2 A cost of service study is an engineering-economic study, which apportions the  
3 revenue, expenses, and rate base associated with providing natural gas service to designated  
4 groups of customers. It indicates whether the revenue provided by the customer group  
5 recovers the cost to serve those customers. The study results are used as a guide in  
6 determining the appropriate rate spread among the groups of customers.

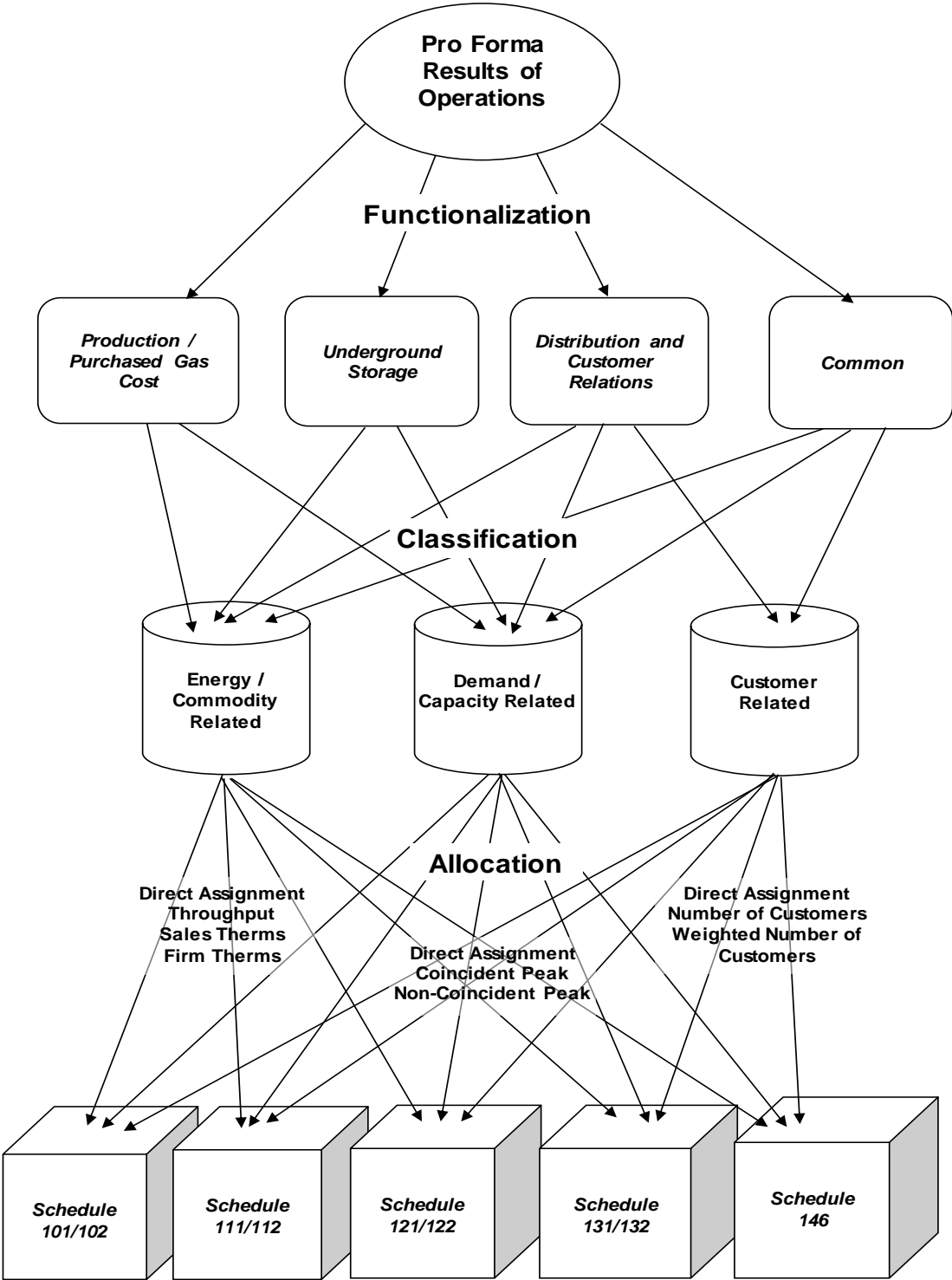
7 As shown in the flowchart below, there are three basic steps involved in a cost of  
8 service study: functionalization, classification, and allocation.

9 First, the expenses and rate base associated with the natural gas system under study  
10 are assigned to functional categories. The FERC uniform system of accounts provides the  
11 basic segregation into production, underground storage, and distribution. Traditionally,  
12 customer accounting, customer information, and sales expenses are included in the  
13 distribution function and administrative and general expenses and general plant rate base are  
14 allocated to all functions. In this study I have created a separate functional category for  
15 common costs. Administrative and general costs that cannot be directly assigned to the  
16 other functions have been placed in this category.

17 Second, the expenses and rate base items are classified into three primary cost  
18 components: demand, commodity or customer-related. Demand-related (capacity) costs are  
19 allocated to rate schedules on the basis of each schedule's contribution to system peak  
20 demand. Commodity-related (energy) costs are allocated based on each rate schedule's  
21 share of commodity consumption. Customer-related items are allocated to rate schedules  
22 based on the number of customers within each schedule. The number of customers may be  
23 weighted by appropriate factors such as relative cost of metering equipment. In addition to

1 these three cost components, any revenue-related expense is allocated based on the  
2 proportion of revenues by rate schedule.

3 **NATURAL GAS COST OF SERVICE STUDY FLOWCHART**



24 **Pro Forma Results of Operations by Customer Group**

1           The final step is allocation of the costs to the various rate schedules utilizing the  
2 allocation factors selected for each specific cost item. These factors are derived from usage  
3 and customer information associated with the test period results of operation.

#### 4                                   **BASE CASE COST OF SERVICE STUDY**

##### 5                   **Production - Purchased Natural Gas Costs**

6           The Company owns no natural gas production facilities serving the Washington  
7 jurisdiction. In addition, the revenue and expenses associated with the natural gas  
8 purchased to serve sales customers, and pipeline transportation to get it to our system, have  
9 been removed from the Company's filing. The natural gas costs included in the production  
10 function in this rate case include the expenses of the gas supply department.

11           The expenses of the gas supply department recorded in account 813 are classified as  
12 commodity-related costs. The gas scheduling process includes transportation customers, so  
13 estimated scheduling dispatch labor expenses are allocated by throughput. The remaining  
14 gas supply department expenses are allocated 95% by sales volumes (excludes Schedule  
15 146) and 5% on total throughput.

##### 16                   **Underground Storage**

17           Underground storage rate base, operating and maintenance expenses are classified as  
18 commodity-related. Thirteen percent of underground storage costs are allocated to customer  
19 groups by annual throughput, the remaining eighty-seven percent are allocated by sales  
20 therms.

##### 21                   **Distribution Facilities Classification (Peak and Average)**

22           Distribution mains and regulator station equipment (both general use and city gate  
23 stations) are classified as demand and commodity-related using the peak and average ratio  
24 for the distribution system. Peak demand is defined as the average of the five-day sustained

1 peaks from each of the most recent three years. Average daily load is calculated by dividing  
2 annual throughput by 365 (days in the year). The average daily load is divided by peak load  
3 to arrive at the system load factor of 38.63%. This proportion is classified as commodity-  
4 related. The remaining 61.37% is classified as demand-related. Meters, services and  
5 industrial measuring & regulating equipment are classified as customer-related distribution  
6 plant. Distribution operating and maintenance expenses are classified (and allocated) in  
7 relation to the plant accounts they are associated with.

#### 8 **Customer Relations Distribution Cost Classification**

9 Customer service, customer information and sales expenses are the core of the  
10 customer relations functional unit which is included with the distribution cost category. For  
11 the most part these costs are classified as customer-related. Exceptions include  
12 uncollectible accounts expense, which is considered separately as a revenue conversion  
13 item, and Demand Side Management amortization expense recorded in Account 908.

#### 14 **Distribution Cost Allocation**

15 Demand-related distribution costs are allocated to customer groups (rate schedules)  
16 by each group's contribution to the three-year average five-day sustained peak.  
17 Commodity-related distribution costs are allocated to customer groups by annual  
18 throughput. The throughput allocation for distribution main investment has been segregated  
19 into small, medium and large mains. Small mains are defined as less than two inches,  
20 medium mains are 2 and 3 inches, and large mains being four inches or greater. Large  
21 usage customers (Schedules 131/132 and 146) receive zero allocation of small main and  
22 33.3% of medium main.

23 Most customer-related costs are allocated by the annualized number of customers  
24 billed during the test period. Meter investment costs are allocated using the number of

1 customers weighted by the relative current cost of meters currently in service. Services  
2 investment costs are allocated using the number of customers weighted by the relative  
3 current cost of typical service installations. Industrial measuring and regulating equipment  
4 investment costs are allocated by number of customers weighted by industrial meters at  
5 current cost.

#### 6 **Administrative and General Costs**

7 General and intangible rate base items are allocated by the Company's four-factor  
8 allocator. Administrative and general expenses are segregated into plant-related, labor-  
9 related, revenue-related and other. The plant-related items are allocated based on total plant  
10 in service. Labor-related items are allocated by operating and maintenance labor expense.  
11 Revenue-related items are allocated by pro forma revenue. Other administrative and general  
12 expenses are allocated by the Company's 4-factor.

#### 13 **Special Contract Customer Revenue**

14 Several special contract customers receive transportation service from the Company.  
15 Rates for these customers were individually negotiated to cover any incremental costs as  
16 well as some contribution to margin. The rates for these customers are not being adjusted in  
17 this case. The revenue from these special contract customers has been segregated from  
18 general rate revenue and allocated back to all the other rate classes by relative rate base. In  
19 treating these revenues like other operating revenues, their system contribution reduces costs  
20 for all rate schedules.

#### 21 **Revenue Conversion Items**

22 In this study uncollectible accounts, state excise tax, and commission fees have been  
23 classified as revenue-related and are allocated by pro forma revenue. These items vary with  
24 revenue and are included in the calculation of the revenue conversion factor. Income tax

1 expense items are allocated to schedules by net income before income tax adjusted by  
2 interest expense.

3 For the functional summaries on pages 2 and 3 of the cost of service study, these  
4 items are assigned to the component cost categories. The revenue-related expense items  
5 have been reduced to a percent of all other costs and loaded onto each cost category by that  
6 ratio. Similarly, income tax items have been assigned to cost categories by relative rate base  
7 (as is net income).

8 The following matrix outlines the methodology applied in the Company's Base Case  
9 natural gas cost of service study.

Line Account	Functional Category	Classification	Allocation
<b>Underground Storage Plant</b>			
1 350 - 357 Underground Storage	Underground Storage	Commodity to match PGA items	E01/E04 Annual Throughput / Annual Sales Therms
<b>Distribution Plant</b>			
2 374 Land	Distribution	Demand/Commodity/Customer from Other Dist Plant	S05 Sum of accounts 376-385
3 375 Structures	Distribution	Demand/Commodity/Customer from Other Dist Plant	S05 Sum of accounts 376-385
4 376(S) Small Mains	Distribution	Demand/Commodity by Peak & Average	D01/E06 Annual throughput excludes Sch 131/132&146 D01/E01/E06 1/3 annual throughput to all schedules & 2/3's annual throughput excluding Schs. 131/132&146
5 376(M) Medium Mains	Distribution	Demand/Commodity by Peak & Average	D01/E01/E06 Annual throUGHT to all schedules
6 376(L) Large Mains	Distribution	Demand/Commodity by Peak & Average	D01/E01 Coincident peak (all), annual throughput (all)
7 378 M&R General	Distribution	Demand/Commodity by Peak & Average	D01/E01 Coincident peak (all), annual throughput (all)
8 379 M&R City Gate	Distribution	Demand/Commodity by Peak & Average	C02, Customers weighted by current typical service cost
9 380 Services	Distribution	Customer	C03, Customers weighted by average current meter cost
10 381 Meters	Distribution	Customer	C06, Customers weighted by industrial meter cost
11 385 Industrial M&R	Distribution	Customer	S05 Sum of accounts 376-385
12 387 Other	Distribution	Demand/Commodity/Customer from Other Dist Plant	
<b>General Plant</b>			
13 389-399 All General Plant	Common	Demand/Commodity/Customer from UG & D Plant	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers
<b>Intangible Plant</b>			
14 303 Misc Intangible Plant	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service 4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers
15 303 Computer Software	Common	Demand/Commodity/Customer from UG & D Plant	
<b>Reserve for Depreciation</b>			
16 Underground Storage	Underground Storage	Commodity same as related plant	Allocations linked to related plant accounts
17 Distribution	Distribution	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
18 General	Common	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
19 Intangible	Distribution/Common	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
<b>Other Rate Base</b>			
20 Accumulated Deferred FIT	All	Demand/Commodity/Customer from Plant in Service	S17 Sum of Total Plant in Service
21 Constuction Advances	Distribution	Customer	C10 Residential only
22 Gas Inventory	Underground Storage	Commodity from Underground Storage Plant	S14 Sum of Underground Storage Plant in Service
23 DSM Investment	Distribution	Demand/Commodity by Peak & Average	D01/E01 Coincident peak (all), annual throughput (all)
24 Working Capital	Common	Demand/Commodity/Customer from UG & D Plant	S17 Sum of Total Plant in Service
25 Other Rate Base	Common	Demand/Commodity/Customer from UG & D Plant	S17 Sum of Total Plant in Service
<b>Purchased Gas Expenses</b>			
26 804 Purchased Gas Cost	Production	Demand/Commodity from PGA Tracker WACOG	Excluded from Study
27 807 Purchased Gas Expenses	Production	Commodity	Excluded from Study
28 813 Gas Research Contributions	Production	Commodity	E08 GTI Expense (Weighted Annual Sales Therms)
29 813 Other Gas Expenses	Production	Commodity	E01/E04 Annual Throughput / Annual Sales Therms



Line	Account	Functional Category	Classification	Allocation
<b>Underground Storage O&amp;M</b>				
1	814 - 837 Underground Storage Exp	Underground Storage	Commodity	E01/E04 Annual Throughput / Annual Sales Therms
<b>Distribution O&amp;M</b>				
2	870 OP Super & Engineering	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service
3	871 Load Dispatching	Distribution	Commodity	E01 Annual throughput
4	874 Mains & Services	Distribution	Demand/Commodity/Customer from related plant	S06 Sum of Mains and Services Plant in Service
5	875 M&R Station - General	Distribution	Demand/Commodity from related plant	S08 Sum of Meas & Reg Station - General Plant in Service
6	876 M&R Station - Industrial	Distribution	Customer from related plant	S19 Sum of Meas & Reg Station - Industrial Plant in Service
7	877 M&R Station - City Gate	Distribution	Demand/Commodity from related plant	S09 Sum of Meas & Reg Station - City Gate Plant in Service
8	878 Meter & House Regulator	Distribution	Customer from related plant	S07 Sum of Meter and Installation Plant in Service
9	879 Customer Installations	Distribution	Customer	C05, Customers weighted by average current meter cost
10	880 Other OP Expenses	Distribution	Demand/Commodity/Customer from other dist expenses	S04 Sum of Accounts 870 - 879 and 881 - 894
11	881 Rents	Distribution	Demand/Commodity/Customer from other dist expenses	S04 Sum of Accounts 870 - 879 and 881 - 894
12	885 MT Super & Engineering	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service
13	886 MT of Structures	Distribution	Demand/Commodity/Customer from Other Dist Plant	S05 Sum of accounts 376-385
14	887 MT of Mains	Distribution	Demand/Commodity from related plant	S21 Sum of Distribution Mains Plant in Service
15	889 MT of M&R General	Distribution	Demand/Commodity from related plant	S08 Sum of Meas & Reg Station - General Plant in Service
16	890 MT of M&R Industrial	Distribution	Customer from related plant	S19 Sum of Meas & Reg Station - Industrial Plant in Service
17	891 MT of M&R City Gate	Distribution	Demand/Commodity from related plant	S09 Sum of Meas & Reg Station - City Gate Plant in Service
18	892 MT of Services	Distribution	Customer from related plant	S20 Sum of Services Plant in Services
19	893 MT of Meters & Hs Reg	Distribution	Customer from related plant	S07 Sum of Meter and Installation Plant in Service
20	894 MT of Other Equipment	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service
<b>Customer Accounting Expenses</b>				
21	901 Supervision	Customer Relations	Customer	C01 All customers (unweighted)
22	902 Meter Reading	Customer Relations	Customer	C01 All customers (unweighted)
23	903 Customer Records & Collections	Customer Relations	Customer	C01 All customers (unweighted)
24	904 Uncollectible Accounts	Revenue Conversion	Revenue	R03 Retail Sales Revenue
25	905 Misc Cust Accounts	Customer Relations	Customer	C01 All customers (unweighted)
<b>Customer Service &amp; Info Expenses</b>				
26	907 Supervision	Customer Relations	Customer	C01 All customers (unweighted)
27	908 Customer Assistance	Customer Relations	Customer	C01 All customers (unweighted)
28	908 DSM Amortization	Distribution	Demand/Commodity by Peak & Average	D01/E01 Coincident peak (all), annual throughput (all)
29	909 Advertising	Customer Relations	Customer	C01 All customers (unweighted)
30	910 Misc Cust Service & Info	Customer Relations	Customer	C01 All customers (unweighted)
<b>Sales Expenses</b>				
31	911 - 916 Sales Expenses	Customer Relations	Customer	C01 All customers (unweighted)

Line Account	Functional Category	Classification	Allocation
<b>Admin &amp; General Expenses</b>			
1 920 Salaries	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
2 921 Office Supplies	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
3 922 Admin Expenses Transferred	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
4 923 Outside Services	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
5 924 Property Insurance	Common	Demand/Commodity/Customer from Plant in Service	S17 Sum of Total Plant in Service
6 925 Injuries & Damages	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
7 926 Pensions & Benefits	Common	Demand/Commodity/Customer from Labpr O&M	S13 O&M Labor Expense
8 927 Franchise Requirements	Revenue Conversion	Revenue	R01 Retail Sales Revenue
9 928 Regulatory Commission	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
10 928 Commission Fees	Revenue Conversion	Revenue	R01 Retail Sales Revenue
11 930 Miscellaneous General	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
12 931 Rents	Common	Demand/Commodity/Customer from Other O&M	4-Factor (O&M less resource & labor, O&M labor, net direct plant, & customers)
13 931 CSS Rent	Customer Relations	Customer	C01 All customers (unweighted)
14 935 MT of General Plant	Common	Demand/Commodity/Customer from Plant in Service	S17 Sum of Total Plant in Service
<b>Depreciation Expense</b>			
15 Underground Storage	Underground Storage	Commodity same as related plant	Allocations linked to related plant accounts
16 Distribution	Distribution	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
17 General	Common	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
18 Intangible	Distribution/Common	Demand/Commodity/Customer same as related plant	Allocations linked to related plant accounts
<b>Taxes</b>			
19 Property Tax	All	Demand/Commodity/Customer from related plant	S14/S15/S16 Sum of UG Plant/Sum of Dist Plant/Sum of Gen Plant
20 Miscellaneous Dist Tax	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service
21 State Excise Tax	Revenue Conversion	Revenue	R01 Retail Sales Revenue
22 Federal Income Tax	Revenue Conversion	Revenue	R02 Net Income before Taxes Less Interest Expense
23 Deferred FIT	Revenue Conversion	Revenue	R02 Net Income before Taxes Less Interest Expense
24 ITC	Revenue Conversion	Revenue	R02 Net Income before Taxes Less Interest Expense
<b>Operating Revenues</b>			
25 Revenue from Rates	Revenue	Revenue	Pro Forma Revenue per Revenue Study
26 Special Contract Revenue	All	Demand/Commodity/Customer from Rate Base	S01 Sum of Rate Base
27 Off System Sales	Production	Commodity	E04 Sales Therms
28 Miscellaneous Service Revenue	Distribution	Demand/Commodity/Customer from Dist Plant	S15 Sum of Distribution Plant in Service
29 Rent From Gas Property	All	Demand/Commodity/Customer from Rate Base	S01 Sum of Rate Base