BEFORE THE WASHINGTON UTILITIES AND

TRANSPORTATION COMMISSION

UE-030751

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)
Complainant,	)
v.	)
AVISTA CORPORATION, d/b/a AVISTA UTILITIES,	)
Respondent.	)

2003 ENERGY RECOVERY MECHANISM PRUDENCE REVIEW

REDACTED VERSION

DIRECT TESTIMONY OF

DONALD W. SCHOENBECK

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

August 25, 2003

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Donald W. Schoenbeck. I am a principal of Regulatory & Cogeneration Services, Inc. ("RCS"), a utility rate and economic consulting firm. My business address is 900 Washington Street, Suite 1000, Vancouver, WA 98660.

Q. PLEASE DESCRIBE YOUR BACKGROUND AND EXPERIENCE.

A. I've been involved in the electric and gas utility industries for over 25 years. For the majority of this time, I have provided consulting services for large industrial customers addressing regulatory and contractual matters before numerous state commissions, public utility governing boards, governmental agencies, state and federal courts, the National Energy Board of Canada and the Federal Energy Regulatory Commission ("FERC"). I have appeared before the Washington Utilities and Transportation Commission ("WUTC" or "Commission") at least 20 times since 1982. A further description of my educational background and work experiences is summarized in ICNU Ex. ____ (DWS-1).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am testifying on behalf of the Industrial Customers of Northwest Utilities ("ICNU"). ICNU is a non-profit trade association, whose members are large industrial customers served by electric utilities throughout the Pacific Northwest, including Avista Utilities ("Avista" or "the Company").

I. INTRODUCTION AND SUMMARY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. ICNU has asked me to examine the $18.4 million (including interest) in power costs deferred by Avista under its Energy Recovery Mechanism ("ERM"), from July 1, 2002,

through December 31, 2002 (the "2002 ERM Period"). It is ICNU's position that not all of these costs are appropriate for recovery.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. ICNU recommends that the Commission reduce Avista's $18.4 million ERM balance by $4.4 million. This results in a total recovery of $14.0 million, as depicted on ICNU Ex. ___ (DWS-2) at line 23. This exhibit replicates Avista's methodology of calculating the ERM deferral, but modifies the balance, based on ICNU's proposed disallowance. ICNU's proposed disallowance relates to only two issues regarding Avista's ERM costs in this proceeding: 1) the appropriate ERM treatment of Avista's buyout of its Enron contract; and 2) the implications on the ERM balance of the delay in the commercial operation date of the Coyote Springs 2 generating project ("CS2"). ICNU recommends excluding $1.765 million associated with Avista's Enron contract buyout costs from current period expenses, and reducing the ERM balance by $2.65 million to account for the delay in the operation of CS2. ICNU Ex. ___ (DWS-2) at lines 23-24; ICNU Ex. ___ (DWS-5) at lines 23-24.

Q. DOES ICNU'S PROPOSED DISALLOWANCE MEAN THAT THE REMAINDER OF THE ERM BALANCE WAS PRUDENTLY INCURRED?

A. No, not necessarily. ICNU limited its review in this proceeding to the issues described above. Other parties in this proceeding may propose approximate disallowances that further reduce the ERM balance.

II. ERM BACKGROUND

Q. PLEASE DESCRIBE THE BACKGROUND AND PURPOSE OF THE ERM.

A. On May 23, 2002, ICNU, Public Counsel, Commission Staff, and Avista entered into a Stipulation ("Stipulation") that resolved a number of outstanding issues in Avista's

general rate case in Docket No. UE-011595. The Stipulation provided that Avista would implement an ERM in its electric operations beginning July 1, 2002, and that the Commission would conduct a prudence review of the costs deferred under the ERM each year. The Commission approved the Stipulation in its Fifth Supplemental Order in Docket No. UE-011595. WUTC v. Avista, WUTC Docket No. UE-011595, Fifth Supp. Order (June 18, 2002).

The purpose of the ERM was to allow the Company the opportunity to recover, or to return to ratepayers, amounts attributable to deviations from authorized levels for certain fuel and power-related costs. As was noted in the Commission's Fifth Supplemental Order in UE-011595, the ERM was intended to cover "ordinary" variations in power supply costs. UE-011595, Fifth Supp. Order at 15. It certainly was not ICNU's intent that the ERM would allow recovery associated with extraordinary events such as extended plant outages. In addition, from ICNU's perspective, a central focus during the negotiations was the ratemaking treatment afforded to certain gas contracts that Avista had entered into with various parties. We believed that the ERM provided a reasonable sharing of these contract costs between the Company and ratepayers.

Q. PLEASE DESCRIBE THE PROCEDURE SET OUT IN THE STIPULATION FOR THE PRUDENCE REVIEW AND AUDIT OF THE ERM.

A. Paragraph 4.b of the Stipulation outlines the procedure for the ERM review:

> Annual Filing to Review Deferrals: The Company agrees to make an annual filing on or before April 1st of each year to provide opportunity for the Commission and interested parties to review the prudence of and audit the ERM deferral entries for the prior calendar year. The Company will respond to data requests within 10 days to allow the Commission Staff and interested parties the opportunity to review the deferral information during a 90-day review period ending June 30th of each year. The 90-day review

period may be extended by agreement of the parties participating in the review, or by Commission order.

On March 28, 2003, Avista made an initial filing for the prudence review and audit of the amounts deferred during the 2002 ERM Period. The Commission subsequently ordered Avista to make an evidentiary filing to justify the prudence of the amounts deferred under the ERM. WUTC v. Avista, WUTC Docket Nos. UE-030751, UE-011595, Sixth Supp. Order (May 27, 2003). Avista filed testimony and exhibits in this docket on June 23, 2003.

Q. WHAT INFORMATION, DOCUMENTS, AND DATA DID YOU REVIEW IN ORDER TO ANALYZE AVISTA'S 2002 ERM POWER COSTS?

A. I reviewed Avista's March 28, 2003 filing and the ERM reports for the relevant time period, read the Company's direct testimony and exhibits filed on June 23, 2003, and examined the Company's discovery responses in this docket.

III. PRUDENCE ISSUES

Enron Contract Buyout

Q. PLEASE DESCRIBE THE COMPANY'S CONTRACT WITH ENRON AND EXPLAIN HOW THE COMPANY ACCOUNTED FOR THE BUYOUT OF THE ENRON CONTRACT IN THE 2002 ERM PERIOD.

A. [redacted] Avista reflected this Enron contract buyout in the October

2002 ERM report as a purchase power expense (Account 555).

Q. PLEASE DESCRIBE YOUR PROPOSED TREATMENT OF THE ENRON CONTRACT BUYOUT COSTS AND THE REASONS SUPPORTING YOUR PROPOSED TREATMENT.

A. The Commission should remove the costs associated with the Enron contract buyout from the 2002 ERM Period for a number of reasons. First, during the settlement discussions with Avista that resulted in adoption of the ERM, ICNU noted that any contract buyout expenses should be reflected over the life of the contract and not recorded as a current expense. Although initially ICNU made this point with regard to certain of the Company's gas contracts, this "contract term" accounting treatment is the only equitable way to prevent the gaming of the ERM when the Company seeks to recover costs associated with termination of any agreement.

Q. PLEASE EXPLAIN THE PROBLEMS THAT MIGHT ARISE IF AVISTA WAS NOT REQUIRED TO USE THE "CONTRACT TERM" ACCOUNTING METHOD.

A. If Avista was not required to reflect contract buyout costs over the life of the contract under the ERM, the Company could have, for example, entered into the gas contracts about which ICNU was concerned, sold off all the gas volumes, and recorded the above-market charge in the ERM as a current expense. Such a result would significantly alter the careful balance of ratepayer-shareholder cost responsibility for these contracts established under the ERM. Under this balance, Avista shareholders are responsible for the first $9 million of cost overruns each year. Without "contract term" accounting, Avista could shift its costs to years when it is likely to exceed the $9 million deadband by terminating contracts. The Commission should prohibit this type of gaming.

Q. WHAT IS YOUR SUGGESTED TREATMENT OF THE ENRON CONTRACT BUYOUT COSTS?

A. Similar to the gas contracts about which ICNU was concerned during settlement negotiations, the costs of the Enron buyout should be reflected in the ERM over the life of the agreement. The cost of the Enron contract termination should be included in the ERM over a 36-month period beginning January 1, 2004. This better reflects the sharing of costs between customers and shareholders that was intended under the ERM. Removing the Enron contract termination charge from Avista's October 2002 purchase power expenses reduces the Company's total costs for the 2002 ERM Period by $1.765 million (including interest), as shown by ICNU Ex. ___ (DWS-3) at line 24.

Coyote Springs 2

Q. PLEASE DESCRIBE HOW THE COMPANY HAS TREATED THE COSTS ASSOCIATED WITH CS2.

A. In the general rate case, the Company included in rates a pro forma adjustment reflecting the complete commercial operation of its 50% ownership interest in CS2. At the time of the Company's filing in UE-011595, CS2 was projected to be in service by June 1, 2002. UE-011595, Avista Ex. ___ (DMF-T) at 23, lines 9-10 (November 30, 2001). The associated pro forma adjustments reflecting the CS2 costs total about $27.8 million for the Washington jurisdiction. For the six-month review period of this ERM filing, the revenue requirement associated with CS2 was about $14.7 million. The fixed-cost portion of these amounts is $15.1 million and $7.5 million, respectively.

Q. WAS CS2 IN SERVICE ON JUNE 1, 2002?

A. No. CS2 did not begin commercial operation until July 1, 2003. This was almost thirteen months after the expected in-service date projected by the Company in the

general rate case.

Q. WHAT EVENTS CONTRIBUTED TO THE DELAY IN THE COMMERCIAL OPERATION OF CS2?

A. As noted by the Company, a portion of this delay was attributable to the Enron bankruptcy, because Avista had retained a subsidiary of Enron as a contractor on the CS2 project. Avista Ex. ___ (TJC-T) at 3. The delay attributable to this circumstance was approximately two months. Id. The remaining delay was attributable to a series of events associated with the failure of the three-phase step-up transformer used in CS2. Id. at 3-12.

Q. PLEASE DESCRIBE THE NEED FOR A STEP-UP TRANSFORMER AND THE DIFFERENCE BETWEEN SINGLE-PHASE TRANSFORMERS AND THREE-PHASE TRANSFORMERS.

A. Virtually all generating stations require a step-up transformer. The purpose of the step-up transformer is to boost the voltage at which the power is generated (the "low side" transformer voltage—typically 13.8 kV) to a level whereby the power can be transmitted to load areas. This "high side" or transmission level voltage can be 115,000, 230,000, 345,000 or 500,000 volts. Another aspect of transformer voltage design has to do with the number of voltage levels required for transformation. Transformers can have more than one "low side" voltage and more than one "high side" voltage or a combination of the two.

In addition to the design voltage(s), transformers are built as a "single-phase" or "three-phase" unit. Because power is generated in three phases, a power plant could utilize three single-phase generating step-up transformers or a single three-phase transformer. Generally, these aspects of transformer design are considered in terms of trade-offs between economics (the cost of building the transformers) and reliability (the

outage time required to replace a failed unit).

Q. CAN YOU PROVIDE AN EXAMPLE OF THE ECONOMIC TRADE-OFFS OF DIFFERENT TRANSFORMER DESIGNS?

A. Yes. Comparing the generator step-up transformer at CS2 with its "sister" unit at Portland General Electric's ("PGE") Coyote Springs 1 ("CS1") illustrates the economic trade-offs of different designs. Both combined cycle plants have a turbine generator and a steam generator. The output voltage of the turbine generator is 13.8 kV while the output voltage of the steam generator is 18 kV. Both plants also have step-up transformers with two low-side voltages to connect to both the steam and turbine generators and one high-side voltage (500 kV) to connect to the transmission grid.

An important design difference between the two units, however, is that CS1 has three single-phase transformers (four counting the spare transformer), while CS2 has a single three-phase transformer. Undoubtedly, PGE's four single-phase transformers cost more than a comparable three-phase unit when combined with the requisite siting costs. Consider, however, the implications of a failure of a step-up transformer, which is a critical piece of equipment in any generating facility. In the case of CS1, a unit can be replaced in just a few days because a spare unit is on site. The ready availability of a spare transformer allows CS1 to be up and running again very quickly.

CS2's single three-phase step-up transformer, on the other hand, is "one-of-a-kind," with two low-side voltages stepping all the way up to 500 kV in a three-phase unit. There are ***no other identical transformers in the United States***. See Avista Ex. ___ (TJC-1). As a result, there are no "spares" or portable transformers that Avista can move to the site in order to bring CS2 back on line quickly if a failure occurs. Consequently, a transformer failure at CS1 might result in an outage that lasts a few days, but the same

type of failure at CS2 would likely result in an outage lasting at least six months, because the failed unit would have to be repaired or another transformer built. As described in the testimony of Avista witness Timothy J. Carlberg, Avista experienced such an extended delay in the operational date of CS2 during the 2002 ERM Period due to the failure of the facility's three-phase step-up transformer and the difficulty of replacing or repairing that unit. Avista Ex. ____ (TJC-T) at 3-12.

Q. HOW HAVE THE OPERATIONAL DELAYS AT CS2 AFFECTED THE COST OF THE FACILITY?

A. The operational delays at CS2 have added substantial cost to the plant. The estimated capital cost of CS2 during UE-011595 was about $188 million. The actual cost associated with the plant is now about $250 million. This equates to a Washington jurisdiction cost overrun of $20.5 million ($62 million x 50% ownership x 66.29%) or 33%. Although the entire capital cost of CS2 must undergo a thorough prudence review, the cost overrun would add an additional $4 million to the fixed cost revenue requirement of CS2 if the Commission allowed full recovery.

Q. DO YOU AGREE WITH THE COMPANY'S ANALYSIS OF THE COST IMPLICATIONS OF THE OPERATIONAL DELAY OF CS2?

A. No. The Company's analysis understates the cost implications of not having CS2 available during the 2002 ERM Period by a significant amount. The Company asserts that the cost of the loss of CS2 during the 2002 ERM Period was only $1.4 million on a system basis, or $0.95 million for Washington. Avista Ex. ___ (RLS-T) at 6, lines 10-14. Avista calculated this value based on two important factors: 1) it assumed an in-service date of August 15, 2002; and 2) more importantly, the Company used historic daily spot market prices to value the energy. Simply put, the Company's quantification of the CS2

cost overruns was based on an "*after-the-fact*" analysis. If the Company had used the *forward-looking* analytical method that it used to justify other actions during the 2002 ERM Period, the actual value of the loss of CS2 would have been much greater.

Q. IN WHAT OTHER INSTANCES IN THIS PROCEEDING HAS THE COMPANY UTILIZED A FORWARD-LOOKING ANALYSIS TO QUANTIFY ITS POWER COST SAVINGS?

A. The Company used forward-looking analyses to quantify the power cost savings associated with its gas sales. In response to Staff data request number 178, the Company provided confidential documentation on each sale of gas covering the 2002 ERM Period. As part of this documentation, the Company provided a spreadsheet that estimated the power cost savings associated with the decision to sell gas, instead of using that gas to generate electricity that would then be sold into the forward market. The Company calculated the power cost savings for each transaction.

In the Company's spreadsheets, it modeled CS2 as an available resource up until the date of the CS2 transformer failure. The Company did not include CS2 in the analysis, however, for transactions that occurred after the transformer failure, beginning with the May 17, 2002 valuation. ICNU Ex. ___ (DWS-4), lines 1-15 presents a summary of the Company's results.

For the fourteen transactions that the Company entered into from May 17th through November 20th, the Company calculated $3.5 million in power cost savings (as shown on line 15 of ICNU Ex. ___ (DWS-4)) for the 2002 ERM Period. Lines 16 through 30 of this same page present the ICNU analysis, which approximates the Company's approach, but assumes that CS2 was available for generation up to 130 MW. With a much lower heat rate and variable operating and maintenance cost, it was more

economical to use the gas to produce electricity to sell into the market in many cases than to sell the gas directly into the market. Had CS2 been available during this period, the Company's result would have changed by $6.4 million. Id. at line 31.

Q. WHY IS THERE SUCH A SIGNIFICANT DIFFERENCE IN THE COMPANY'S AFTER-THE-FACT CALCULATION OF THE VALUE FOR THE LOSS OF CS2 DURING THE 2002 ERM PERIOD AND THE FORWARD-LOOKING CALCULATION?

A. The dramatic difference in this result—$6.4 million using the forward-looking analysis, as compared to the $1.4 million "after-the-fact" spot market valuation—is attributable to the difference in market prices used in the analysis. For example, in the Company's spot market approach, the average price of gas in September was $3.15/Mcf. The average of the daily Mid-Columbia prices used by the Company for this same month were $25.5/MWh for the on-peak period, and $22.7/MWh for the off-peak period. With these values, the Company calculated an economic loss due to the unavailability of CS2 of only $222,000 for the entire month of September. See ICNU Ex. ___ (DWS-4) at line 34.

In the forward-looking assessment used by the Company to support the May 17th gas sale, the September forward gas price was $3.32/Mcf, and the electric prices were $42/MWh during the on-peak period, and $34/MWh during the off-peak period. By locking in these prices, the Company would have profited by about $373,000 by generating at CS2. See ICNU Ex. ___ (DWS-4) at line 16. Furthermore, this gas sale transaction was for just 5,000 Mcf/day, or about 25% of Avista's CS2 capacity, as compared to the Company's spot market analysis, which used 100% of the CS2 capacity.

Q. SHOULD THE COMMISSION ADJUST THE ERM BALANCE BASED ON THE COMPANY'S UNDERVALUATION OF THE LOSS OF CS2 DURING THE 2002 ERM PERIOD?

A. Yes. The Commission should adjust the proposed ERM balance to take into account the

lost opportunities from not having CS2 available during the 2002 ERM Period for several reasons. First, the extraordinary length of the outage (thirteen months) was never an event that ICNU imagined that the ERM would cover. As with any protracted unit outage, the ratemaking treatment of the costs associated with these unique circumstances needs to be addressed independently from a purchase power cost mechanism such as the ERM.

Second, Washington ratepayers have been paying 100% of the fixed costs associated with CS2 in rates even though it did not achieve commercial operability during the 2002 ERM Period. As noted earlier, these revenue requirement costs associated with CS2 for the 2002 ERM Period alone are about $7.5 million. To force ratepayers to pay for 90% of the replacement power costs (through the ERM) of CS2 in addition to 100% of the fixed costs of a plant that was not used and useful during the 2002 ERM Period is entirely inequitable. In future rate proceedings before this Commission, fixed cost recovery should not be allowed or assumed until the plant achieves commercial viability.

Finally, it also is inappropriate for customers to bear all costs associated with Avista's questionable decision to rely solely on a three-phase step-up transformer. It is unreasonably risky for a utility to rely exclusively on a transformer that is so extraordinarily unique in its design that no replacement can be found within the United States. Customers should not bear all of the risk associated with questionable decisions on the part of the Company.

Q. WHAT IS YOUR RECOMMENDATION REGARDING AN ADJUSTMENT TO REFLECT THE LOSS OF CS2 DURING THE 2002 ERM PERIOD?

A. For the purpose of determining an adjustment to the ERM balance, ICNU proposes to

employ the average of the two opportunity analyses set forth on ICNU Ex. ___ (DWS-4). In other words, ICNU's proposed adjustment equals one-half of the difference between the market value of the plant based upon the Company's forward price projections and the after-the-fact spot market analysis. However, ICNU has added about $33,000 to the Company's spot market analysis (see line 35), to reflect the market value had CS2 been in service for the full ERM period.

As shown on line 37 of ICNU Ex. ___ (DWS-4), the adjustment is almost $4.4 million on a system basis. As shown on line 24 of ICNU Ex. ___ (DWS-5), the adjustment is $2.6 million including interest for the Washington jurisdiction. ICNU believes this adjustment is equitable because it captures the likely market value had the plant been on line during this period, as well as the fixed cost contribution paid by the Washington ratepayers.

Q. PLEASE SUMMARIZE THE OVERALL ADJUSTMENT THAT YOU ARE RECOMMENDING IN THIS DOCKET.

A. The CS2 adjustment, when combined with the Enron adjustment proposed by ICNU, results in an ERM balance of $13.9 million, plus $114,000 of associated interest expense for the 2002 ERM Period. This represents an approximately $4.4 million reduction in the ERM balance calculated by Avista, as shown on ICNU Ex. ___ (DWS-2) at lines 21-22. ICNU recommends that the Commission adopt this disallowance as part of its final order in this Docket.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.