Report on Natural Gas Procurement Practices
of
Avista Corporation

Docket UG-121501

On Behalf of Public Counsel

March 8, 2013

REDACTED

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I. Introduction

A. Commission Concerns and Objectives

The Commission issued a complaint and order suspending the Purchased Gas Adjustment (PGA) filing of Avista Corporation (Avista or Company) on October 31, 2012.[1] The Commission allowed the proposed rate decrease to go into effect on a temporary basis, subject to revision. The Commission's Order stated that an investigation is warranted to determine whether the natural gas procurement and hedging practices of Avista result in fair, just, reasonable, and sufficient rates.

The Commission further stated that it would hold hearings and conduct workshops as may be required, and required Staff to file a report on the status of the investigation no later than March 1, 2013, including a recommendation on the disposition of the tariff filing by Avista or the need for further process to make the appropriate determination.

B. Public Counsel Objectives

The issues and concerns raised by Staff and the Commission are also of great concern to Public Counsel. Retail customers have paid higher rates as a result of the gas procurement policies and practices of Avista during the past decade.

In this report, we will outline our initial findings and preliminary recommendations for continuation of this proceeding and improvements to the PGA mechanism. Our approach in this review was not solely to assess past performance and examine any potential failings of the Company's gas procurement practices, but also to propose ways to make future PGA proceedings more robust and transparent.

We issued in excess of 30 data requests inquiring on a variety of issues related to the PGA and the underlying gas procurement policies and practices of the Company, and particularly its price hedging program. Data requests covered the period 2003 to 2013 for the following areas:

- The information filed in the annual PGA and Deferred Gas Cost Account regulatory proceedings and support information.
- Gas supply sources and related purchase pricing arrangements.
- The cost of gas passed on to customers during each year.
- Interstate transportation and gas storage capacity.
- Price hedging policies and procedures.
- Specific price hedging transactions.
- Hedging gains, losses and costs of fixed price gas purchase contracts.
- The percent of the gas portfolio hedged and how early price hedges were placed before actual gas delivery.

[1] *WUTC v Avista,* Docket No. UG-121501, Order 01 (October 31, 2012).

- Hedging tools and methods employed.
- Analysis on the cost and effectiveness of the hedge program.
- Corrective steps taken to minimize price hedging costs to customers.

The Company provided answers to some, but not all, of the data requests for the time period covered. In this analysis we also reviewed and made extensive use of the responses and data requested by Staff. In our analysis, we were often hampered by insufficient information provided by the Company.

The cost of gas passed on to customers through the PGA mechanism represents from 75% to 80% of the customer's gas bill. Yet, the amount of regulatory scrutiny that it receives pales in comparison to the level of scrutiny for a general rate case that impacts about 20-25% of the customer gas bill. The Commission must have a deeper understanding of how the Company's gas procurement policies and practices, and particularly price hedging strategies, will impact customer bills before those policies and strategies are implemented.

C. Report Author

To analyze the gas procurement and hedging strategies of the Company and to prepare this report of findings and recommendations, the Public Counsel employed the services of Mr. Sebastian Coppola, President of Corporate Analytics, Inc. Mr. Coppola is a gas industry expert intricately familiar with regulated natural gas utilities, gas price hedging programs and gas cost recovery mechanisms similar to the PGA.

He has more than thirty years of experience in public utility and related energy work, both as a consultant and utility company executive. He has testified in several regulatory proceedings before State Public Service Commissions. He has prepared and filed testimony in gas cost recovery mechanisms, gas general rate case proceedings, revenue and cost tracking mechanisms and riders, and other regulatory proceedings.

During his tenure at SEMCO Energy, a natural gas utility with 260,000 customers, he held the position of Chief Financial officer and also had responsibility for certain storage and pipeline operations as President and COO of SEMCO Energy Ventures, Inc. Prior to SEMCO, Mr. Coppola was Senior Vice President of Finance for MCN Energy Group, Inc., the parent company of Michigan Consolidated Gas Company (MichCon). MichCon is a gas utility with more than a million customers and $1.4 billion in revenue.

In his role as Treasurer and Chairman of the MCN/MichCon Risk Committee from 1996 through 1998, Mr. Coppola was involved in reviewing and deciding on the appropriate gas purchase price hedging strategies, including the use of gas future contracts, over the counter swaps, fixed price purchases and index price purchases.

In March 2001, Mr. Coppola testified before the Michigan House Energy and Technology Subcommittee on Natural Gas Fixed Pricing Mechanisms. Mr. Coppola participates in natural gas issue forums sponsored by the American Gas Association and stays current on various energy supply issues through review of industry reports and other publications issued by various trade groups.

Appendix A provides more details on Mr. Coppola's experience and regulatory credentials.

D. Key Definitions

Financial hedging – The use of financial tools, such as price swap agreements, futures contracts, option contracts, etc., where a financial counterparty guarantees a fixed price for a set volume of gas to be delivered at a specified location for a specified period of time. The Company will buy gas in the spot market and the gas utility will make a payment to the financial counterparty if the spot market price is lower than the fixed price. If the spot market price is higher than the fixed price, the financial counterparty will make a payment to the gas utility to get its cost of gas down to the fixed price.

Hedging losses – The difference between an agreed to fixed price and the spot market price in the month of delivery of the gas, where the fixed price is higher than the spot market price.

Hedging gains – The difference between an agreed to fixed price and the spot market price in the month of delivery of the gas, where the fixed price is lower than the spot market price.

Physical hedging – An arrangement between the utility and a gas supplier to deliver an agreed volume of gas at a specified location at a fixed price for a specified period of time.

Physical hedging cost and benefits – Hedging losses and gains generally relate only to financial hedging. With regard to physical hedging there are not losses or gains per se, since the utility does not settle with a financial counterparty. In a physical hedge, the utility agrees to buy a quantity of gas at a fixed price with a gas supplier and pays that price when the gas is delivered. In these transactions, there is a cost premium or a benefit that is calculated against the spot market price. So, a physical hedging cost premium occurs when the fixed price exceeds the spot market price in the month the gas is delivered. A physical hedging benefit occurs when the fixed price is below the spot market price in the month the gas is delivered.

II. Executive Summary

A. Summary of Findings

The initial findings from our preliminary review of the Company's gas procurement and hedging program has shown the following:

1. The Company's gas price hedging program has resulted in large losses and higher cost of gas for retail customers.
2. For the 2011-2012 PGA year, we estimate Cascade's customers incurred approximately **[Begin Confidential]** XXXXXXXX**[End Confidential]** in higher gas costs from both financial and physical price hedging. Of this amount, **[Begin Confidential]** XXXXXXX **[End Confidential]** applies to Washington customers.
3. Based on limited information provided by Avista, we estimate that the Company's fixed price hedging has caused more than **[Begin Confidential]** XXXXXXX **[End Confidential]** in higher gas costs over the past 10 years for Cascade's customers, of which more than **[Begin Confidential]** XXXXXXX**[End Confidential]** were absorbed by Washington customers.

4. Avista's hedging strategy of locking in gas prices up to **[Begin Confidential]** XXX XXX **[End Confidential]** before the gas is actually needed has not significantly reduced PGA rate volatility.
5. The 50% or more of total gas supply that the Company has recently hedged is relatively high and has not proven to have been beneficial to customers over the past 10 years.
6. The Company has continued generally on the same path of locking in fixed prices even in the face of mounting hedging losses and significantly above market fixed price hedges.
7. As a result of price hedges put in place in prior years, significantly higher gas costs and hedge losses will continue into 2013 and future years.
8. We find that the Company did not act prudently to limit hedge losses and higher gas costs during the 2011-2012 PGA year.
9. The Company also has had large volumes of off-system gas sales which may have resulted in index and fixed price gas purchases being sold at a loss because of excess supplies during the year.
10. Additionally, the Company has released a significant amount of **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXX **[End Confidential]** This would result in added costs being passed on to customers through the PGA rate.
11. The current PGA and Deferred Gas Cost Adjustment procedures do not provide sufficient scrutiny of gas procurement practices and do not provide an early warning of potentially costly strategies, such as price hedging that may harm customers.

B. Summary of Recommendations

Based on our initial findings and analysis, we make the following preliminary recommendations:

1. The Commission should consider disallowing at least **[Begin Confidential]** XXXXXXX **[End Confidential]** from gas costs included in the current Deferred Gas Cost Account. As explained in greater detail later in this report, we base this conclusion on the fact that the Company entered into fixed price financial hedges within **[Begin Confidential]** XXXXXXXX **[End Confidential]** from the start of the 2011-2012 PGA year, when clear evidence existed from prior months that cash spot market prices were much more advantageous than forward hedge prices.
2. The Commission should order the Company to reduce the Deferred Gas Cost Adjustment tariff rate to reflect the disallowance.
3. The Commission should order the Company to suspend entering into any new hedging transactions until it has received recommendations from Staff, Public Counsel and other parties on an appropriate hedging program in collaboration with the Company.

4. The Commission should order Staff to organize and lead a Technical Collaborative with the Company and Public Counsel. The purpose of the Collaborative is to develop recommendations to the Commission on appropriate price hedging guidelines, policies and technical aspects of an effective hedging program, including percentages of the gas supply to be hedged, the length or window in which to hedge and acceptable hedging tools to minimize hedging costs.
5. In conjunction with or separately from the investigation in the current docket, the Commission should undertake a rule making process to modify and strengthen the PGA initial filing requirements and the subsequent gas cost reconciliation. The Commission should include the following objectives in initiating a new rule making for the PGA in order to achieve more uniformity:
    a. The annual PGA filing should include testimony that describes the entire gas procurement plan in detail and with exhibits identifying sources of supply, short and long term gas purchase arrangements, forecasted pricing, price hedging strategies, pipeline transportation arrangements and cost, gas storage utilization plans, gas sales forecast including peak day demand and plans on how to meet that peak demand.
    b. The PGA filing should also include a forecast of gas costs, sources and strategies for the subsequent four years. This longer term forecast would provide an early warning of events that could significantly affect gas prices.
    c. At the end of the PGA year, the Company would file a gas recovery reconciliation case presenting testimony to explain its actual gas supply procurement decisions and costs with detailed cost schedules and exhibits.
    d. Both the PGA filing and Cost Gas Recovery reconciliation proceedings should be contested cases similar to a rate case to ensure transparency and a full assessment of the prudency and reasonableness of the utility gas supply purchase decisions.
    e. The PGA rate could be adjusted at least quarterly, if needed, to reflect changes in actual versus forecasted gas costs. This would insure customers get charged for gas costs in the year incurred and not in subsequent years as currently done with the deferred gas cost account.

These recommendations will result in more robust and transparent regulatory oversight to ensure gas costs have been appropriately reviewed by the Commission and found to be reasonable and prudently incurred. A more robust and transparent process also will give customers renewed confidence that the largest cost component of their gas bills is receiving sufficient scrutiny and appropriate oversight by the Commission.

It is also worth noting that a significant number of Regulatory Commissions in States such as Michigan, Maryland, New Jersey, Ohio and Pennsylvania have moved from a simplified PGA filing procedure to a more robust regulatory process similar to the one outlined above.

III. Profile of Avista Corporation[2]

Avista generates, transmits and distributes electricity and distributes natural gas in parts of eastern Washington, northern Idaho and Oregon. The utility also engages in wholesale purchases and sales of electricity and natural gas. As of December 31, 2012, the Company employed 1,682 people in its utility operations.

At the end of 2012, the Company supplied retail natural gas service to 323,000 customers across its entire service territory in parts of eastern Washington, northern Idaho, and northeastern and southwestern Oregon. Retail natural gas customers include residential, commercial and industrial classifications. The Company delivered approximately 1.1 billion therms in 2012 with 314 million therms to retail gas customers. Revenues from natural gas operations were $474 million.

The Company purchases natural gas supplies from basins in the western United States and western Canada and delivers those supplies to its distribution system through firm capacity rights on six pipeline networks. The interstate pipeline delivery capacity provides the ability to serve approximately 25 percent of peak natural gas customer demands from domestic sources, and 75 percent from Canadian sources.

The Company procures natural gas through a mix of spot market purchases, forward fixed price purchases, and derivative instruments from various supply basins and over various time periods. Based on projections of natural gas loads, the Company executes a series of transactions to hedge a significant portion of its projected natural gas requirements through forward market transactions and derivative instruments. These transactions extend for multiple years into the future with the highest volumes hedged for the current and most immediate upcoming natural gas operating year. Avista also purchases a portion of its natural gas supply requirements in short-term and spot markets. In 2012, Avista purchased approximately 920 million therms.

Avista also uses natural gas storage capacity to support high demand periods and to procure natural gas when prices may be seasonally lower. The Company owns a one-third interest in the Jackson Prairie Natural Gas Storage Project (Jackson Prairie), an underground natural gas storage field located near Chehalis, Washington. Jackson Prairie has a total peak day deliverability of 11.5 million therms, with a total working natural gas capacity of 253 million therms. Avista has a one-third share of the peak day deliverability and total working capacity.

Under Purchase Gas Adjustment (PGA) clauses, the Company is allowed to adjust natural gas rates periodically (with regulatory approval) to reflect increases or decreases in the cost of natural gas purchased. Differences between actual natural gas costs and the natural gas costs included in retail rates are deferred during the period the differences are incurred. During the subsequent period when regulators approve inclusion of the cost changes in rates, any amounts that were previously deferred are charged or credited to expense. The Company typically proposes new PGA rates at least once per year.

[2] Information obtained from Avista 2012 report on Form 10-K.

IV. Major Findings

A. Gas Procurement Policies and Practices

Gas Supply Purchases, Sources and Pricing Methods – The Company has disclosed that for the period November 2011 to 2012, it obtained natural gas supplies from three supplies sources: the AECO Hub, the Sumas Hub and the Rockies area basin.[3] The AECO source accounted for 74% of the total purchases with Rockies and Sumas supplies at 16% and 10%, respectively. Given that both the AECO and SUMAS supply sources import natural gas from Canada, combined these sources make up 84% of the total supply. The percentage of gas supply sourced from these basins is significantly different from prior years. In the prior five years, the Company sourced approximately 61% from AECO and 28% from the Rockies.

The Company did not provide information prior to November 2006, so it is not possible to assess how its long term supply strategy may have changed over time.

The Company reported that it buys supplies at spot/index prices. However, from the information provided it is not clear if the Company utilizes solely index prices at the specified hubs or if it also uses field index prices and NYMEX spot prices and assumes basis differential risk.

In its annual PGA filings, the Company did not specify its supply sources, pricing or strategy in any great detail. Therefore, it is difficult to conclude whether or not its basic gas procurement practices are prudent and reasonable at this time

Price Hedging Policies and Strategies – The Company has employed price hedging strategies for many years with the objective of locking in a fixed price for a percentage of its gas purchases. The Company's Energy Resources Risk Policy **[Begin Confidential]** XXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[4]

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. **[End Confidential]** For the 2011-2012 PGA year, the Company fixed the price on approximately 50% of its gas purchases.[5] The percentage was **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[6] **[End Confidential]** The Company did not provide information on the total percent hedged (financial and physical) for years prior to the 2005-2006 PGA year, as requested.

The Company's Risk Policy **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXX.

[3] Avista Response to Public Counsel Informal Data Request No. 17.
[4] Avista Responses to Staff Informal Data Request No. 6 (Confidential) and Public Counsel Informal Data Request No. 19 (Confidential).
[5] Avista Response to Staff Informal Data Request No. 17.
[6] Avista Response to Public Counsel Informal Data Request No. 24 (Confidential).

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Results of Price Hedging – The Company was asked to report the results of its price hedging strategies using either financial or physical contracts during the past ten years. The Company was able to only report results from 2005 to 2013 for financial hedges and only for last four years for physical contract hedges. For this limited period, the Company reported hedging losses and costs of **[Begin Confidential]** XXXXXX, **[End Confidential]**as shown in Table 1 below.[7] It is instructive to note that the Company incurred losses in every year during this seven-year period, even in those years in 2007-2008 when gas prices were rising rapidly.

Table 1 (Confidential)

[**Begin Confidential]**

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[End Confidential]

[7] Avista Response to Public Counsel Informal Data Request No. 24, Supplemental Response (Confidential).

Financial Hedging[8] –For only the 2011-2012 PGA year, the Company entered into financial contracts to lock in **[Begin Confidential]** XXXXXXXXXXXXXXX **[End Confidential]** of gas purchases. Financial hedges began in **[Begin Confidential]** XXXXX **[End Confidential]** The Company locked in prices averaging **[Begin Confidential]** XXXXX. **[End Confidential]** The average index/spot market price at time of settlement was **[Begin Confidential]** XXXXXXXX XXXXX **[End Confidential]** lower. Based on this difference, the financial hedges resulted in a in a loss of more than **[Begin Confidential]** XXXXX **[End Confidential]**for the 2011-2012 PGA period.

Physical Hedging[9] – Hedging gas prices by using fixed price physical contracts is basically no different than using financial contracts. The approach is different but the results are usually the same. For the 2011-2012 PGA year, the Company entered into fixed price gas supply contracts for **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXX. **[End Confidential]** The Company locked in prices averaging **[Begin Confidential]** XXXXXX. **[End Confidential]** When compared to the average index/spot market prices of **[Begin Confidential]** XXX **[End Confidential]** per Dth in the month the gas was delivered, the fixed price physical purchases resulted in a cost premium of more than **[Begin Confidential**] XXXXXX **[End Confidential]** for the 2011-2012 PGA year.

Therefore, combined the two hedging methods resulted in higher costs to Avista gas customers in the amount of **[Begin Confidential]** XXXXXXXXXXXXXX. **[End Confidential]** The portion applicable to Washington customers is 69% or **[Begin Confidential]** XXXXX **[End Confidential]** for the 2011-2012 PGA. Although the Company did not provide fixed price purchases data for the entire 10-year period under review, it is likely that system-wide losses and cost premiums to customers due to the hedging program have exceeded **[Begin Confidential]** XXXXXXXX **[End Confidential]**

Off-System Gas Sales – In balancing natural gas retail load requirements with resources, the Company engages in off-system sales of natural gas (wholesale purchases and sales). Wholesale sales are delivered through wholesale market facilities outside of the natural gas distribution system and, when feasible, physical delivery may be avoided through offsetting purchase and sale book-out arrangements. Natural gas resource optimization activities include wholesale market sales of surplus natural gas supplies, and purchases and sales of natural gas to optimize use of pipeline and storage capacity.

It is not clear from the information provided by the Company at what prices the off-system sales are occurring. If the sales are occurring primarily as a result of surplus natural gas supplies, it is likely that off-system sales are occurring at spot market prices. With the Company purchasing 50% of its gas supplies at fixed prices significantly above spot/index prices, it is possible that off-system sales in certain months are resulting in a financial loss and an incremental cost to retail customers.

Unfortunately the current PGA and Deferred Gas Cost Account process does not allow an opportunity to scrutinize these transactions to ensure they are reasonable, prudent and necessary.

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[8] Avista Response to Public Counsel Informal Data Request No. 24, Supplemental Response (Confidential).
[9] *Id.*

Pipeline Transportation Capacity – The Company uses a network of interstate pipelines to transport natural gas to its distribution system and gas storage facilities. The Company plans for sufficient natural gas delivery capacity to serve its retail customers on a theoretical peak day. During non-peak day periods, it generally has more pipeline and storage capacity than needed. To generate economic value and partially offset gas costs, the Company will release pipeline capacity in the open market and earn fees.

[Begin Confidential] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXX.[10] XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXX.

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The level of pipeline capacity, which is reflected in the PGA tariff, and the capacity release transactions do not appear to be sufficiently scrutinized in the current annual PGA/Deferred Gas Cost Account process. Thus, there is not an opportunity to ensure the Company has contracted for the appropriate level of capacity and that gas costs have been reasonably and prudently incurred.

B. Assessment of Gas Procurement Practices

Avista Hedging Policy Objectives – The Company has stated that its **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX.[11]
[End Confidential]

The hedging losses and cost premiums paid over the past 10 years clearly indicate that the Hedging Policy objectives have not been met. They have not minimized gas costs for Avista

[10] Avista Response to Staff Informal Data Request No. 19 (Confidential).
[11] Avista Response to Public Counsel Informal Data Request No. 19(f) and 19(g) (Confidential).

customers. To the contrary, my analysis above shows that the Company has incurred large losses and cost premium year after year which have harmed gas customers.

PGA Rate Volatility – A review of the PGA rates charged to customers from 2007 to 2012 shows that the hedging program has not provided as much rate stability as claimed or intended. The following table shows that PGA rates, including the annual deferred account cost adjustments, have varied significantly. The accompanying line graph below shows clearly the volatility in the combined PGA rate.

Table 2

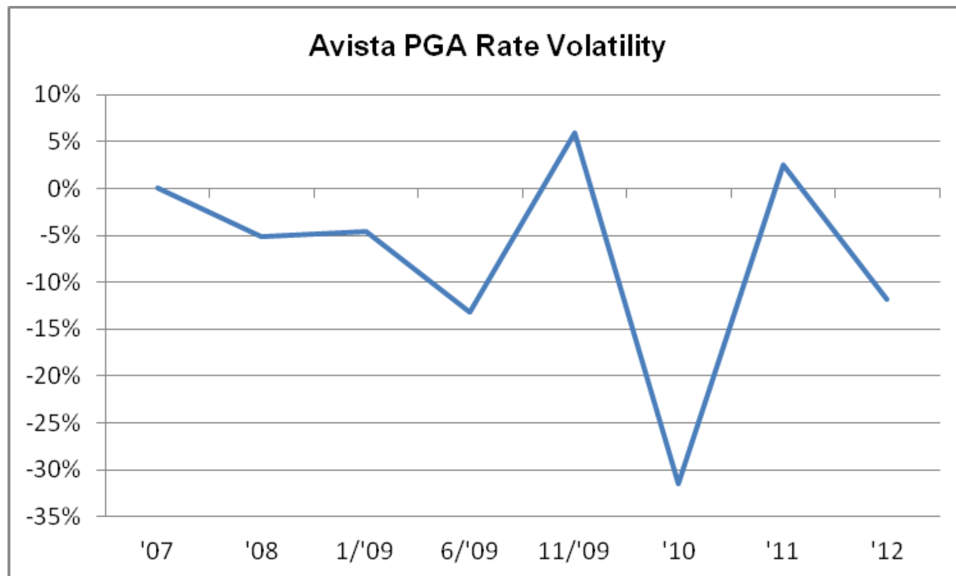
Avista PGA Rates in ¢ Per Therm

Date	PGA WACOG[1]	PGA Adjustment[2]	Total PGA Rate	Percent Inc. (Decr.)
11/1/2007	84.697	(0.300)	84.397	
11/1/2008	84.697	(4.653)	80.044	-5%
1/1/2009	84.697	(8.371)	76.326	-5%
6/1/2009	84.697	(18.399)	66.298	-13%
11/1/2009	84.697	(14.472)	70.225	6%
11/1/2010	55.981	(7.872)	48.109	-31%
11/1/2011	52.379	(3.031)	49.348	3%
11/1/2012	46.817	(3.322)	43.495	-12%

[1] Schedule 150 for rate schedule 101.

[2] Deferred Account adjustment from Schedule 155.

Table 3



When we also consider the fact that the Company has experienced consistent financial hedging losses and higher gas costs at least since 2005, it is obvious that the fixed price hedging program has not served retail customers well.

Analysis of Hedging for 2011-2012 PGA Year – It is perplexing why the Company would continue with following the same hedging strategies year over year in the face of mounting losses and higher gas costs. In a data request, the Company was asked if it had evaluated its hedging program over the past years to assess its effectiveness and if it had taken steps to improve it. The response reiterated the Company's risk policy and gas procurement strategy, but did not identify any studies and corrective steps that had been taken.[12]

Disregarding the negative impact that the hedging program was causing to utility customers is inconsistent with the Company's duty to minimize gas costs. In the most recent two PGA years, it should have been quite obvious that spot market prices were significantly outperforming the forward market prices. Yet, the Company continued to hedge up to a 50% level of its gas purchases by locking in fixed prices in the upcoming prompt year. In my opinion, this was a very imprudent decision.

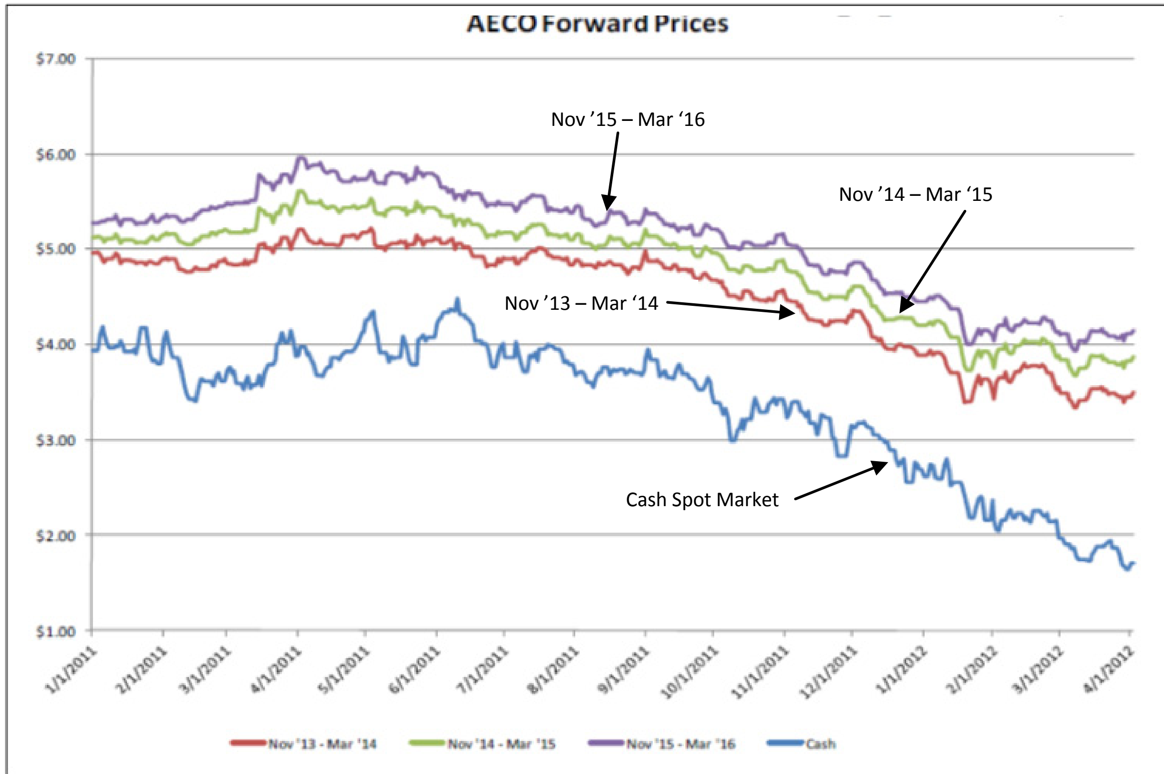
The following chart in Table 4 clearly shows this large gap between the AECO forward prices and the cash spot market price. This information was certainly available to the Company and should have given management a reason to pause on any further hedging for the upcoming years.

Nevertheless, the Company continued to hedge for the coming year (prompt year). A review of the hedges entered into for the 2011-2012 PGA year shows that by **[Begin Confidential]** XXX XXX **[End Confidential]** the Company had executed hedges of **[Begin Confidential]** XXXX XXXXXXX **[End Confidential]** of the total planned hedges and was still planning to hedge 2,992,500 Dth for the coming year. The expected hedge price on the yet un-hedged physical trades was **[Begin Confidential]** XX **[End Confidential]** and for the financial hedges was **[Begin Confidential]** XXX **[End Confidential]** per Dth. At the end of **[Begin Confidential]** XXXXX **[End Confidential]**, the closing Gas Daily index spot market price typically used by the Company was $1.82 per Dth. Yet, the Company proceeded with hedging an additional **[Begin Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX **[EndConfidential]**.

Appendix B (Confidential) shows the hedging trades entered from July 2011 to December 2011 for the **[Begin Confidential]** XXXXXXXX **[End Confidential]** and the resulting financials losses and cost premium paid over spot market prices.

[12] Avista Response to Public Counsel Informal Data Request No. 27.

Table 4



Disallowance of Gas Costs – In my opinion, the Company was imprudent in proceeding with fixing the price on **[Begin Confidential]** XXXXX **[End Confidential]** which were still un-hedged as of **[Begin Confidential]** XXXXXXXXXXXX **[End Confidential]** before the beginning of the 2011-2012 PGA year. Most of the evidence pointed to a significant differential between the cash spot market and the future prices that the Company eventually locked in. Furthermore, the historical losses and past experience with locking-in high gas prices should have given the Company reason to reduce the amount and percentage of hedged volumes. In other words, why continue on the same strategy that had created losses and increased gas costs for customers year after year. The Company's decisions were neither reasonable nor prudent and ultimately hurt customers. Therefore, as shown in Appendix B, I recommend that the Commission consider disallowing at least **[Begin Confidential]** XXXXXX **[End Confidential]** from recovery of gas costs from the Company's deferred gas cost account and order the Company to file a revised tariff to reflect this disallowance.

Suspend Hedging Program – Also, the Commission should order the Company to suspend its current hedging strategy until Staff and the Public Counsel have had an opportunity to review that strategy in more detail and recommend appropriate modifications in collaboration with the Company. Experience with similar hedging programs at other utilities has shown that the hedging window can be shortened from **[Begin Confidential]** XXXXXXX **[End Confidential]** to less than one year and the utility can still achieve significant reduction in gas price volatility. Most importantly, with a shorter window the price of the hedged volumes is more reflective of

current spot market prices, therefore avoiding large losses and gains. Although gas prices may appear attractive today against historical levels and the temptation exists to try and lock in perceived attractive prices for future gains, such practice would be pure price speculation and not a sound strategy to reduce price volatility.

There are also significant issues with regard to off-system sales and pipeline transportation capacity that need to be addressed going forward. The Commission should consider undertaking additional rule making to revamp the PGA filing process to ensure adequate regulatory scrutiny of these costs take place in a more robust PGA review process. This topic will be discussed in more detail later in this report.

C. Assessment of PGA Regulatory Process

Under the current regulatory procedures outlined in WAC 480-90-233, the Company is required to:

1. Make a PGA filing within a maximum of fifteen months since the effective of last PGA or file supporting documents demonstrating why a rate change is not necessary.
2. Accrue the difference between actual gas costs and the amount billed to customers in a deferred account and accrue interest on the balance at the FERC rate.
3. File a monthly report showing the activity in the deferred account.

WAC 480-90-194 and other applicable rules require the Company to provide public notification to customers about any rate changes and also follow other filing procedures.

PGA Filing – A review of the PGA filings since 2006 shows that typically the Company will make a filing two to three months before the start of the next PGA year to update both the Weighted Average Cost of Gas (WACOG) rate and the Deferred Gas Cost Account Adjustment rate. This Adjustment rate recovers or refunds the difference between billed and actual gas costs for the prior year.

The filings typically consist of a few schedules providing a summary of gas commodity purchases and pipeline transportation costs. Most of the exhibits show the amount of gas costs that is allocated between regulatory jurisdictions and the Washington customers' rate schedules. Considerable detail is also provided about the calculation of demand and commodity tariff rates for each customer rate schedule. The package is usually accompanied by a two page letter summarizing this information and pointing out unusual events and compliance with the customer notification rules.

What is clearly lacking from the package is a comprehensive discussion of the Company's gas procurement plan for the coming year, including purchases it plans to make from each basin, the price assumptions, the annual and peak day demand it forecasts, the amount of pipeline capacity needed to meet peak demand, the utilization of gas storage versus winter purchases, the short term and long term price hedging strategies, the expected cost of hedging versus spot market prices and other gas procurement strategies to minimize the cost of gas to customers. This discussion should be supported by detailed volume and cost schedules. Without this information it is not possible for Staff, Public Counsel and other parties, who have an interest in these

proceedings, to adequately assess that the proposed PGA rates and WACOG are reasonable and in the best interest of customers.

The current concern with the amount of hedging losses accumulated by Washington gas utilities has highlighted the fact that gas procurement issues have not had sufficient visibility and scrutiny. The hedging issue would not have been a surprise in recent months if a more rigorous regulatory oversight process would have been in place.

Deferred Account Balance Adjustment Filing – A similar concern must be voiced with regard to the gas cost deferred account reconciliation process. From what we have observed, the process is merely an accounting reconciliation. The actual costs included in the account do not undergo any significant regulatory oversight to ensure the amounts and the Company decisions that created those costs were reasonable, prudent and in the best interest of the gas utility customer. The Commission rules and regulatory process do not seem to contemplate a rigorous review. Unlike rate case filings where the Staff and intervenors perform considerable discovery and due diligence reviews, the PGA costs are not reviewed with the same rigor.

Additionally, there is not an easy mechanism for the Company to increase the PGA rate during the current year to recover higher gas costs or reduce the rate to pass through to customers lower gas costs in a timely fashion. The current procedure defers refunding or surcharging millions of dollars of gas costs from the current year, when the costs were incurred, to the following year. This delay potentially shifts the responsibility of gas costs to customers who did not take service in the prior year and now either pay for costs they should not be paying or benefit from a refund of costs they never paid. Each year, the Company has a significant number of customers who disconnect service and move out of the service area. Likewise, a number of customers relocate or begin service in the utility's service area. This turnover in customers reinforces the point that PGA costs and adjustments need to occur as much a possible during the same year.

V. Recommendations

Based on our initial findings and analysis, we make the following preliminary recommendations:

1. The Commission should consider disallowing at least [**Begin Confidential** XXXXXX **[End Confidential]** from gas costs included in the current Deferred Gas Cost Account. We base this conclusion on the fact that the Company entered into fixed price financial hedges within **[Begin Confidential]** XXXXX **[EndConfidential]** from the start of the 2011-2012 PGA year, when clear evidence existed from prior months that cash spot market prices were much more advantageous than forward hedge prices.
2. The Commission should order the Company to reduce the Deferred Gas Cost Adjustment tariff rate to reflect the disallowance.
3. The Commission should order the Company to suspend entering into any new hedging transactions until it has received recommendations from Staff, Public Counsel and other parties on an appropriate hedging program in collaboration with the Company.

4. The Commission should order Staff to organize and lead a Technical Collaborative with the Company and Public Counsel. The purpose of the Collaborative is to develop recommendations to the Commission on appropriate price hedging guidelines, policies and technical aspects of an effective hedging program, including percentages of the gas supply to be hedged, the length or window in which to hedge and acceptable hedging tools to minimize hedging costs.
5. In conjunction with or separately from the investigation in the current docket, the Commission should undertake a rule making process to modify and strengthen the PGA initial filing requirements and the subsequent gas cost reconciliation. The Commission should include the following objectives in initiating a new rule making for the PGA in order to achieve more uniformity:
   a. The annual PGA filing should include testimony that describes the entire gas procurement plan in detail and with exhibits identifying sources of supply, short and long term gas purchase arrangements, forecasted pricing, price hedging strategies, pipeline transportation arrangements and cost, gas storage utilization plans, gas sales forecast including peak day demand and plans on how to meet that peak demand.
   b. The PGA filing should also include a forecast of gas costs, sources and strategies for the subsequent four years. This longer term forecast would provide an early warning of events that could significantly affect gas prices.
   c. At the end of the PGA year, the Company would file a gas recovery reconciliation case presenting testimony to explain its actual gas supply procurement decisions and costs with detailed cost schedules and exhibits.
   d. Both the PGA filing and Cost Gas Recovery reconciliation proceedings should be contested cases similar to a rate case to ensure transparency and a full assessment of the prudency and reasonableness of the utility gas supply purchase decisions.
   e. The PGA rate could be adjusted at least quarterly, if needed, to reflect changes in actual versus forecasted gas costs. This would insure customers get charged for gas costs in the year incurred and not in subsequent years as currently done with the deferred gas cost account.

These recommendations will result in more robust and transparent regulatory oversight to ensure gas costs have been appropriately reviewed by the Commission and found to be reasonable and prudently incurred. A more robust and transparent process also will give customers renewed confidence that the largest cost component of their gas bills is receiving sufficient scrutiny and appropriate oversight by the Commission.