Avista Corporation
Docket No: UG-021584
Natural Gas Benchmark Mechanism
Direct Testimony: Catherine M. Elder
Exhibit ____(CME-1T)

BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET No. UG-021584

DIRECT TESTIMONY OF CATHERINE M. ELDER (CME-1T)

ON BEHALF OF

PUBLIC COUNSEL

NON-CONFIDENTIAL VERSION

JULY 18, 2003

Q: Please state your name, business address, and present position.

A: My name is Catherine M. Elder. My business address is 2710 Gateway Oaks Drive in Sacramento, CA 95833. I am employed by R.W. Beck, Inc., as an Executive Consultant responsible for managing its fuel consulting practice.

Q: Please describe your experience and educational background.

A: I joined R.W. Beck in May 2003 to head up its new fuel consulting practice after twelve years consulting with several firms. While at Navigant Consulting, I performed the natural gas market review and forecast of natural gas prices to support California's record $13 billion bond issue to fund long-term power purchases in the wake of the electricity crisis; I assisted in the negotiation of certain of the state's power contracts containing gas tolling provisions, and have worked on developing or assessing fuel supply and transportation plans for power projects all over the West. As a consultant, I have testified in several California gas regulatory proceedings, addressing issues such as market-based rates for an underground gas storage provider, long-run marginal cost, and various policy issues relating to the structure of gas transportation and procurement service in California. While at Pacific Gas and Electric from 1985 - 1991, I helped develop gas transportation and procurement policies to protect core ratepayers, including helping to decide how to open PGT to competition. My undergraduate degree is in the Political Economy of Industrial Societies from the University of California, Berkeley, and I hold a Master's Degree in Public Policy from the John F.

Kennedy School of Government at Harvard University. A detailed curriculum vitae is attached as Exhibit _____, CME-2.

Q: What is your role in this proceeding?

A: I am testifying on behalf of the Public Counsel section of the Attorney General's Office and am providing it with technical support regarding the natural gas market.

Q: Please describe the purpose of your testimony.

A: My testimony addresses whether Avista Corporation's (Avista) proposed gas procurement incentive mechanism ("benchmark mechanism") is appropriate in light of natural gas market conditions and to provide some perspective on whether the mechanism can be improved.

Q: Briefly describe your conclusions.

A: I recommend that the Commission reject Avista's proposed benchmark mechanism. Avista's benchmark mechanism proposal does not establish a clear benchmark for measuring Avista's success or failure in achieving lower gas costs. It rewards Avista Energy (AE) too easily for everyday market decisions that should be taken as a matter of course by a prudently managed gas utility, and does not properly motivate Avista to achieve a lower cost of gas for its AU ratepayers. If the Commission chooses to approve the mechanism over these objections, it should at least incorporate several modifications to Avista's proposal which I will recommend.

Q: What do you see as the logical premise for regulatory commissions to adopt procurement incentive mechanisms?

A: Procurement incentive mechanisms have been created for some, but not nearly all local distribution companies in the U.S., in order to reflect the concept that allowing a local distribution company (LDC) to retain a share of the benefits when it achieves lower gas costs for its ratepayers should motivate it to work harder to achieve lower gas costs. Procurement incentives are an alternative to a plain "pass-through" mechanism, by which an LDC passes its actual cost of gas, no more and no less, on to its ratepayers, often after a finding that the costs were incurred prudently. Some LDCs felt that prudence review put them "at risk" for being found imprudent in procuring natural gas, with no opportunity for a reward if they did well. In response to these general concerns, the Commission adopted a set of policy principles in Docket No. UG-940778 to guide its LDCs in presenting procurement incentive proposals to the Commission for review and potential approval.

Q: Do you find that the Avista proposal adequately satisfies the principles outlined in the Policy Statement?

A: No, it does not satisfy the principles articulated in the Commission's Policy Statement. Specifically, Avista's proposal is inconsistent with Principle Nos. 1, 2, 3, 7, 9, 15, and arguably 12. Most notably, the sharing mechanism proposed by Avista is not "based on a comparison of actual gas costs to a benchmark," as articulated in Principle No. 1, because Avista proposes no actual benchmark and

no comparison of costs to a benchmark cost of gas. This Commission and Avista's ratepayers have no way of determining, under this proposal, whether Avista does a good job of managing their gas costs. The Commission should reject Avista's proposal. If the Commission decides to continue the benchmark mechanism in some form, it should make several modifications to Avista's proposal to remedy the concerns discussed below.

Q: Please describe a typical incentive structure.

A: A typical structure establishes a reasonable benchmark cost of gas (e.g. a certain dollar amount per MMBtu or a formula used to calculate an average gas cost) that reflects what ratepayers should expect to pay if the gas were purchased by a prudent gas manger without an incentive mechanism. If and when an LDC "beats" that benchmark to achieve a lower gas cost, it is rewarded with a percentage of the difference between actual cost and the benchmark. In other words, it receives a share of the savings it achieved on behalf of ratepayers. The converse would be true, as well, such that the LDC shares in whatever costs it incurs above the benchmark. It is the measurement of actual gas costs versus the benchmark value that demonstrates how much better or worse off ratepayers are and potentially creates a reward for the LDC.

To reiterate, a properly structured benchmark should be set at what this Commission and its LDC ratepayers expect to see as a reasonable cost of gas. The incentive is awarded when the gas manager does a better job than expected, by achieving lower gas costs. If the benchmark is set too high, the LDC will have

an easy time of beating it and earning a reward it does not truly deserve; likewise, if the benchmark is set too low, the LDC will never be able to beat it and it will not succeed in promoting the actions this Commission and the LDC ratepayers would like in achieving lower gas costs. Importantly, benchmark mechanisms should not simply give the LDC additional profit without producing clearly lower gas costs to ratepayers. Rather, the concept offered by a benchmark is to encourage lower gas costs by offering shareholders a portion of the gas cost savings achieved by the LDC. I cannot emphasize enough that the key question in developing an incentive mechanism is how the benchmark is established: what is the measure used to calculate whether ratepayer savings occurred? Thus, incentive mechanisms should not be designed for the purpose of compensating the gas manager for doing an "average job" of buying gas for ratepayers – traditional prudence reviews and pass-through mechanisms can achieve this result. Incentive mechanisms are intended to reward the LDC for doing better than what it would otherwise do under the prudent gas manager standard. I encourage the Commission, as part of this proceeding, to clarify the intent of incentives and its expectation of LDC behavior under a procurement incentive mechanism.

Q: What is your understanding of Avista's incentive proposal?

A: Conceptually, Avista's proposal simply outlines how it will procure gas – whatever gas costs accrue under that procurement strategy are passed on to ratepayers. Then, Avista has a number of so-called "opportunities" to reduce that

cost of gas; whenever it undertakes an action that reduces that cost, it captures 20% of the benefit.

Q: Please explain in more detail how this works.

A: Avista's proposal creates a cost of gas for ratepayers that are determined as follows:

Total Cost of Gas = Tier I Cost + Tier 2 Cost + Tier 3 Cost

Where:

- Tier 1 volumes are purchased in advance, at fixed prices negotiated anywhere from six to eighteen months in advance to cover 50% of expected demand;
- Tier 2 volumes are purchased at First of Month (FOM) prices averaged over three geographic indices weighted as selected by Avista for the remaining portion of monthly base load demand;
- Tier 3 volumes are purchased at the daily price of Avista Energy's portfolio or at Gas Daily, depending on whether AE bought any gas itself or not.

Volumes to be withdrawn from underground storage are predetermined according to the "synthetic" storage schedule are included in Tier 1 at the average cost of gas in storage inventory; out-of-schedule injection or withdrawal used to balance daily load in Tiers 2 or 3 is priced at the Avista Energy average daily transaction price.

The equation I have just described creates a basic cost of gas to ratepayers that appears to be booked to the Purchased Gas Account (PGA).

The incentive portion of the mechanism allows Avista to share in the "benefit" of

various decisions made "along the way." These include:

a. Any difference between FOM prices and Avista's daily transaction price on Tier 3 daily swing volumes is awarded 20% to Avista;[1]

b. Additional transactions Avista executes from the lowest-cost basin above the basin weighting percentages (called "basin optimization" by Avista) is awarded 20% to AE;[2]

c. When withdrawing gas from storage to serve ratepayer load Avista gets 20% of the difference between the average inventory cost of gas in storage and current FOM prices;

d. When withdrawing gas from storage outside the synthetic schedule (i.e., withdraws gas earlier than planned) Avista gets 20% of the difference between gas prices on the forward curve and that day's price; and

e. When releasing capacity or making an off-system sale bundled with capacity, Avista gets 20% of the difference between the delivery point index price and the receipt point index price.

On top of all this, under the company's proposal, AE would receive $900,000 per year to recover its costs for acting as the fuel manger.

[1] FOM prices are those published in the natural gas trade press, and are sometimes known as the "monthly index." These are the types of prices that are frequently used in gas sales agreements and that are the subject of investigation by the FERC as to whether these prices have been manipulated, given that they are based on transactions reported to the trade publications with little opportunity for verification by the trade publication and certainly none by third parties. Both FERC and a consortium of industry participants have been working to increase the amount of confidence both the public and regulators can have in the accuracy of these indices given how broadly they are used in the industry.

[2] As explained in the testimony of Avista witness Gruber, Avista generally purchases natural gas at three different geographical locations: Sumas, where gas comes into the U.S. from British Columbia; AECO-C, the major gas supply hub in Alberta, and from the Rockies. Avista creates a basin weighting factor, expressed as a percent, to identify how much of its overall gas supply portfolio comes from each of these three locations.

Q: Could you clarify which corporate portion of Avista plays what role in all of this?

A: Avista uses a wholly-owned, unregulated subsidiary, Avista Energy (AE), which is primarily engaged in the business of purchasing and selling natural gas and related commodities to a variety of customers other than utility ratepayers on an unregulated basis, to conduct all of the transactions relating to gas procurement on behalf of Avista's ratepayers. The incentive reward is actually paid to AE, and AE and Avista Utility employees work together in making key decisions on behalf of ratepayers.

Q: Tell us your specific objections to this proposal.

A: My specific objections are that the proposal does not establish a true benchmark against which gas costs are measured and that the additional decisions for which Avista can receive an award are biased in its favor.

Q: How are the reward items biased in AE's favor?

A: First I'll discuss the first two reward items identified above, as their logic is very similar. AE is rewarded with 20% of the difference between the cost of daily swing gas it sells to AU in Tier 3 and the weighted average FOM price. My objection is that the basin-weighted average FOM price is determined under fixed basin weights that by definition do not maximize ratepayer access to the cheapest gas supply basin– while AE's daily purchases of gas can be targeted to that basin,

and may be targeted to that basin using the utility's spare capacity.[3] Thus, it appears there is little chance that AE's daily price would not automatically be lower than the weighted average FOM price on most days. To the extent that there was or is flexibility to increase purchases from the cheapest basin based on transportation capacity Avista owns in order to serve its AU ratepayers, such a decision should be taken as a matter of course and ratepayers should be entitled to that savings without sharing it with AE.

The same basic reasoning applies to the "basin optimization" (reward item number 2, above). It is as though Avista assumes that the basin-weighted cost of gas is the default – AE gets to share in any improvement over that default. However, because the basin weightings are fixed in advance, allowing AE to focus on the cheapest basin, artificially guarantees that AE can offer a lower daily cost of gas than calculated under the basin-weighted cost of gas. If the Commission approves Avista's benchmark I recommend that it eliminate these two incentives, as AE should not be rewarded over price differences which its management expertise does not help to create.

Q: What is wrong with the storage-related reward items included on your list of objections?

A: The cost of gas from storage is determined based on the cost at the time the gas was injected. Under Avista's proposal, injections are priced at the basin-weighted

[3] Avista's weighted average cost of gas to ratepayers is based on a rough 18% Sumas/57% AECO/25% Rockies proportion; efforts to better this percentage are biased in AE's favor since AE's purchases are not constrained according to these same percentages and in fact, AE is theoretically free to purchase all of its daily purchased gas from the least-cost basin.

average cost of gas for that month. This makes sense since most injection gas is from an advance-planned purchase, bought on a base load basis. Withdrawals are priced at the resulting average cost of inventory (generally, the average cost of all the gas that was injected over the injection period). As explained with respect to reward item no. 3 above, AE wants a reward whenever the cost of gas withdrawn from storage is lower than the basin-weighted FOM price for a given month. This is inappropriate. For example, let's think about January: the average cost of gas in inventory (gas that was purchased the previous summer) is likely to be less than January's FOM price. Certainly, there will be years in which a volatile market makes January less expensive than the previous summer's injection gas, but the point is that AE does absolutely nothing to influence either the average cost of gas in inventory (injected each month at FOM) and the winter FOM price. Again, AE should not be rewarded over price differences which its management expertise does not help to create.

The early withdrawal (reward item number 4, above) off the synthetic schedule raises a slightly different issue. In this case, the synthetic schedule sets an expectation about when gas would be withdrawn. I agree with Avista that under certain economic conditions we want ratepayers to benefit if less expensive gas can be withdrawn earlier than scheduled without jeopardizing winter reliability. However, I disagree with how Avista has proposed to implement that concept: it looks at forward prices to determine if it is more economic to use storage gas today rather than at the future planned date established in the synthetic schedule –

the logic being that it could use the gas today and afford to replace it, at an expected lower price, based on what it sees in the forward market. But, under the proposal, AE does not commit that it will go on to lock-in the lower price of that future gas. Ratepayers are therefore left exposed to the risk that cash prices will rise by the time we get to the future date at which gas would have been withdrawn for them but now we have to go purchase it in the FOM or day market. Here is an example where AE does the right economic analysis but doesn't seem to follow-through to use its management acumen to do the job of protecting ratepayers on the back end of the transaction. This can be easily remedied by requiring AE to make the futures trade to complete the hedge. In summary, AE should not be rewarded for making storage decisions while ratepayers are left at risk. If the Commission approves Avista's benchmark, Reward Item 4 should be modified to require AE to make the future trade to complete the hedge.

Q: What is your objection to reward item number 5, as it is identified on your list?

A: Reward item five is sharing of capacity release and off-system sales margins. Avista is proposing a guaranteed benefit to AU ratepayers of $3 million as well as 20% of the benefit of all transactions after that. According to the calculations I present in Exhibit CME-7C, using the data in Avista's response to data request number WUTC DR-60, shows that the total revenue from capacity release activities (excluding off-system sales) has been about $3 million each year.

However, at least with respect to commodity gas costs, the Commission's Policy Statement (see Principle number 4) encourages a comparison to a benchmark of what is achievable, rather than a comparison to historic costs. Applying that concept to capacity release revenues suggests the right comparison is to what should be achievable, not what was achieved previously.

Q: Did you do an analysis to determine what should be achievable with respect to capacity release revenues?

A: Yes. According to WUTC DR-57, Avista holds approximately 172,000 MMBtu per day of interstate pipeline capacity on behalf of AU ratepayers in Washington. As established in Avista confidential Workpaper 3, Avista pays about **BEGIN CONFIDENTIAL** **********END CONFIDENTIAL** per year for using this 172,000 MMBtu per day of capacity to transport gas to Washington ratepayers. This creates an annual average transportation cost of approximately **BEGIN CONFIDENTIAL **********END CONFIDENTIAL**, assuming approximate annual gas throughput of **BEGIN CONFIDENTIAL **********END CONFIDENTIAL**. Using the monthly load profile shown at page 3 in Exhibit RHG-2 (to which I added an additional 10% reserve margin) I calculated the amount of capacity Avista can theoretically release each month. Exhibit _____, CME-4C. By further assuming what percentage of its monthly transport rate is likely recoverable in the market for either capacity release or in the form of an off-system sale, Avista Energy should show revenue for AU ratepayers of **BEGIN CONFIDENTIAL ********** END**

CONFIDENTIAL per year. Recognizing that the 172,000 MMBtu was winter capacity and shaving some off the released revenue recovery, the Commission should modify the Avista benchmark to split capacity release revenues after achieving a guaranteed level of $10 million – in contrast to the $3 million proposed by Avista.

Q: What other comments do you have about the reasonableness of the capacity release reward?

A: I am troubled by how the margin is calculated and whether AE contributes any business skill that affects the results of that calculation. In fact, the margin is calculated merely as the difference between the index cost of gas at the delivery point versus a receipt point for the capacity used to complete the transaction. So AE arguably doesn't create this value – it either exists or it does not. If it exists, AE would presumably enter into a transaction if it has the assets available to complete one.

Additionally, despite a variety of questions posed to Avista, it is unclear what transactions go into the pool for sharing versus what capacity is used to complete the transaction. Exhibit _____, CME-5, Avista's response PC DR-16. We know, for example, that AE owns transportation capacity for serving its customer portfolio beyond utility ratepayers. Sometimes AE is able to combine AU capacity and other capacity in order to complete a release using those combined assets. And AE correctly asserts that it has access to a broader array of counterparties and opportunities the utility acting alone would have. But

according to the answer to data request WUTC DR-60, Avista does not segregate the data between releases done by AE versus releases done by AU. Exhibit _____, CME-7C. Whether this is true for off-system sales is unknown. Thus, there is no way to determine which releases and trades AE makes are within the pool to be shared, which are outside it, and how that determination is made. Nor is there a means to determine what transactions could not have been accomplished by AE without the assets of AU ratepayers. Thus, ratepayers have no objective way of knowing what value they should be compensated as a result of these transactions.

Q: Do your objections to Avista's proposal recognize that AE also shares in 20% of any excess costs on all these "reward items" you have discussed?

A: Yes, it does. The point, however, is that AE is not truly exposed to that 20% risk as long as the reward items are all biased in its favor. Moreover, I think Avista conveniently forgets that it faces risk in prudency review absent adoption of an incentive mechanism. Thus, accepting 20% risk is not incremental risk; if the benchmark were eliminated, a disallowance risk would presumably be substituted. And under this proposal there is no way to tell what their true risk is, in any case. In my opinion, Avista's benchmark creates an imbalance of risks and rewards such that AE faces inappropriately low risks given the scope of rewards it can receive.

Q: Please summarize your objections to Avista's proposal.

A: My objections are that the Avista proposal:

a. grants rewards to AE for "decisions" and price differences for which AE's management exercises no real insight or action to create in order to improve upon the cost of gas for ratepayers that would otherwise occur without AE as the gas manager; and

b. includes features that are biased to virtually guarantee that AE will receive rewards.

In other words, this Commission and Avista's ratepayers cannot tell if they are getting a better deal than they otherwise could without this mechanism.

Q Have you performed any analysis to confirm whether ratepayers are getting a good deal or not?

A: Yes, I have and it appears to me that they are not getting a good deal. Exhibit _____, CME-6 compares Avista's commodity cost of gas for each month to a FOM price weighted according to the 57% AECO/18% Sumas/25% Rockies split identified at page 4 of Exhibit RHG-2. See also, PC DR-9. My analysis shows that, if you assume the simple alternative of purchasing all FOM gas in these percentages, AE's procurement effort resulted in a significantly higher cost of gas to Avista ratepayers than is otherwise available in the market. In fact, AE's results are some $0.75 per MMBtu higher, on average, than under a simple FOM gas strategy. This analysis highlights not only the fact that the structure of Avista's proposal obfuscates whether it is doing a "good job" or not, but that real

attention must be paid to the basin weightings, how much transportation capacity Avista owns on behalf of AU ratepayers, and how much ratepayers should pay for rate stability if FOM prices are deemed too volatile. Avista's proposal does not demonstrate why its proposal, which fails to explicitly evaluate or analyze any of these issues, is better than other alternatives the Commission could adopt.

Q: What is your evaluation of the $900,000 annual management fee?

A: AE receives a $0.05 per MMBtu management fee under the incentive mechanism in place today; the new proposal changes that to a $900,000 fixed fee. AE says that this $900,000 covers its costs (see, for example, Avista's answer to WUTC DR-28). Using an average daily throughput of **BEGIN CONFIDENTIAL ********** END CONFIDENTIAL** per day that I calculated earlier from Avista's confidential workpaper 3, this $900,000 fixed fee turns into a per unit cost of approximately **BEGIN CONFIDENTIAL *** END CONFIDENTIAL** cents per MMBtu. Thus, the $900,000 could be argued to be reasonable. In addition, $0.05 per MMBtu is within the range of fees I have seen charged for similar services, albeit at the high end.

Q: Then what is your objection to the $900,000 management fee?

A: My objection is to the combination of the management fee and the incentive rewards in this biased benchmark mechanism. Under this proposal, AE is too protected from risk to justify a $900,000 fee to recover its costs like a utility would, plus receive an incentive reward on top of the management fee. I would rather see AE be placed at risk to recover its costs as part of the incentive –

especially in the absence of a clear and objective procurement benchmark. Accordingly, I recommend this fee be eliminated.

Q: Should the Commission be concerned about AE being a sister company creating perverse incentives to properly managing AU's gas procurement?

A: Yes. The Commission should be concerned about whether AE can accomplish trades outside the benchmark mechanism that it could not accomplish without access to AU's transportation and storage assets and variation in AU's load. To date, Public Counsel has received less than reassuring responses regarding these transactions – see, for example, Avista's response to PC DR-16, attached to this testimony as Exhibit _____, CME-5.

However, in the response to data request WUTC DR-6, Avista makes a point that is consistent with my observation of other participants in the natural gas market: this Commission will likely have decidedly worse assurances about whether AU ratepayers were properly compensated for all transactions conducted involving "their" assets if an entity further outside the Commission's jurisdiction managed AU's gas portfolio. The Commission will have no better assurances on that issue should the fuel manager activity be contracted out to BP Energy, for example, or any other natural gas supplier from whom the AU activities are not booked individually and separated from other transactions.

Q: How can the Commission address these concerns?

A: I recommend the Commission reject Avista's proposal. However, should the Commission decide to continue the mechanism in some form it should require

Avista to solicit competitive bids for the opportunity to manage its portfolio. That would at least allow the Commission itself to see what other parties might propose and create some competitive pressure for AE to offer ratepayers the best proposal possible. It could also order Avista to create clearer, more concrete separations between AE's transactions on behalf of ratepayers and transactions it conducts as part of its unregulated trading business.

Q: Can the Commission take any comfort by looking at the annual average cost of gas to Avista ratepayers versus the average cost of gas sold to AE's other customers?

A: No, I don't believe it can. In the response to data request PC DR-11, Avista explains that it uses daily mark-to-market accounting for all of the gas transactions in its portfolio. This means that other than on a daily basis, the Commission can never confirm how its ratepayers were treated versus other AE customers.

A brief example will illustrate how daily mark-to-market accounting works. Assume that Avista buys 10,000 MMBtu per day for November through March at a fixed, contract price of $5.25 per MMBtu. Avista now needs to reflect the existence of that contractual commitment on its books. Under daily mark-to-market, the contract is valued at the difference between each day's gas price and the contract price. Thus, if the gas price on day x is $3.00 per MMBtu, the contract is under water by the difference between the contract price of $5.25 and today's price of $3.00. Conversely, as gas prices rise to a level above the $5.25

contract price, the value of the contract on Avista's books becomes positive. Thus, Avista never looks at the contract cost, but at the difference between contract price and each day's price. Avista doesn't bother with knowing the average cost of gas supply it has under contract, but knows how its contracts compare with the market price of gas each and every day. The bottom line is that the value of positions Avista has taken in the market changes every day; under this construct it is not meaningful to think about Avista's average cost of gas over time – it simply isn't accounted for in that manner.

Q: Is Avista's current incentive mechanism any better than the one it is proposing be adopted in this proceeding?

A: In some ways yes, and in some ways, no. Both mechanisms suffer from the same defect that they do not truly establish a reasonable cost of gas that the LDC (or agent) then tries to beat, and thus the Commission can never tell whether ratepayers truly received a lower cost of gas due to the mechanism. Importantly, the Commission should realize that the new proposal shifts risk away from AE, such as that due to daily load swings and associated daily price volatility. AE offers to manage that risk for AU, if AU pays for it. Thus, AE is reducing its risk (vis a vis the current mechanism) and is then being paid to manage that risk for AU under the new mechanism. This is certainly not an improvement for ratepayers. If I had to choose between the existing and the proposed mechanisms to recommend to the Commission, I would pick the existing one over the new proposal as it at least keeps AE at some risk that the new proposal would instead

shift to ratepayers. Importantly though, the existing mechanism also suffers from the basic complaint that it does not offer a true comparison between a benchmark goal and Avista's cost to ratepayers.

Q: Would you propose that an incentive mechanism be adopted for Avista, and if so, what would it look like?

A: I think this Commission should not adopt an incentive mechanism. Based on Avista's proposal and my understanding about the evolution of the mechanism and the proposed changes to it over time, it is evident to me that Avista consistently seeks to reduce its procurement risks without admitting that it is shifting that risk to ratepayers. The risk/reward balance is wrong under Avista's proposal. Instead, the Commission should eliminate the incentive mechanism and work with Avista to consider and articulate what gas purchase results it wants its LDCs to achieve.[4] For example, New Mexico's Public Regulatory Commission in 1997 ordered its LDCs to hedge the cost of gas and has since conducted detailed advance workshops with Public Service New Mexico (PNM) to work with PNM on the LDC's hedging strategy and to assure the Commission that PNM's plans are workable. PNM passes the cost of its hedging activity through to ratepayers in shoulder-months, thereby stabilizing the cost of gas over the course of the year. Either this approach or workshops to better understand LDC gas purchase options and agree upon a true benchmark for measuring LDC gas purchase success or failure would represent a significant improvement for

[4] The Commission should note that the questions of whether Avista should have an incentive mechanism and whether the procurement should be moved back into the utility are separable.

Avista's Washington ratepayers compared to the vague benchmark Avista has proposed. Avista's proposed mechanism shifts increasing amounts of risk back to ratepayers (and then charges them to manage that risk). The Commission needs to ask the threshold question of whether a benchmark is achieving the objective of lowering ratepayers' cost of gas.

If, instead, this Commission decides to adopt a benchmark mechanism, I recommend the Avista proposal be adjusted as follows:

a. Avista should articulate and calculate a clear benchmark, subject to approval by the Commission, that represents an actual target cost of gas achievable by a prudent gas manager and for which AE shares both risk and reward in meeting. Avista's proposed procurement strategy could be used to create a benchmark, but only if it is modified as described below such that AE's opportunity to beat the benchmark is not biased in its favor.

b. Each year, Avista should be rewarded 20% of the savings only after it demonstrates to the Commission, and the Commission agrees, that Avista achieved a cost of gas lower than the calculated benchmark. The provisions granting AE an automatic paycheck when daily prices are lower than FOM or when storage withdrawals are priced lower than FOM, for example, should be removed. Instead, AE should be responsible for taking whatever actions (rather than only specific actions identified in the mechanism) it can to achieve a cost of gas **lower** than that achievable under the target benchmark.

c. AE's reward should not be 20% of a variety of different reward items or decisions it makes, but 20% of the overall cost of gas reduction it delivers to ratepayers through its gas management acumen above and beyond what is expected of a prudent gas manager. In other words, the decisions about use of gas in storage and capacity release should either be included within the benchmark or be subject to separate, specific benchmarks. No rewards for specific decisions should be automatic. If the Commission creates a separate benchmark for capacity release, for example, it should adopt a target benchmark of $10 million in expected capacity release revenues and allow sharing after the target is met.

d. AE should not receive guaranteed cost recovery as embodied in the $900,000 management fee and an incentive reward when it is taking so little risk;

e. AE should lock-in forward prices when it decides to withdraw gas earlier than schedule from storage.

If AE remains responsible for the procurement and management activity, AE should be required to track all transactions undertaken on behalf of AU ratepayers, separate from those undertaken as part of AE's unregulated business activities.

Q: Does this conclude your testimony?

A: Yes, it does.