Agenda Date: September 10, 2003
Item Number: A1

**Docket:** **UG-031361 (Refiling of Docket No. UG-031253)**

Company: Avista Corp., d/b/a Avista Utilities

Staff: Jim Russell, Regulatory Analyst
Mert Lott, Energy Industry Coordinator
Ken Elgin, Case Strategist

**Recommendation:**

Suspend the tariff filing in Docket No. UG-031361 and issue a Complaint and Order of Investigation, but allow the rates to become effective on September 11, 2003, on less than statutory notice, on a temporary basis, subject to refund through the deferral account.

**Background/Nature of the Filing:**

Avista Corp., d/b/a Avista Utilities ("Avista" or "the Utility") is a gas company serving approximately 126,000 natural gas customers in Eastern Washington, including Spokane and surrounding communities.

On August 1, 2003, Avista filed its Purchase Gas Adjustment (PGA) and deferred gas cost amortization tariffs (UG-031253) requesting to increase natural gas rates by approximately $11.8 million (8.7%) annually effective September 5, 2003. On August 21, 2003, Avista withdrew that filing in order to correct the allocation of certain demand cost components within the filing. On August 26, 2003, Avista refiled its PGA and deferred gas cost amortization tariffs under Docket No. UG-031361 reflecting an increase of approximately $11.9 million (8.7%) requesting that the rates become effective September 11, 2003, on less than statutory notice. During the preliminary review of Avista's filing, Staff had requested that Avista withdraw its initial filing and refile its PGA with these certain corrections and agreed to support Avista's request to allow the rates to become effective September 11, 2003.

The Commission's current policy surrounding the use of PGA tariffs for gas utilities is to establish the cost of gas for the upcoming year based on the best projection of what the utility's gas cost will be for the year. The combination of the Purchased Gas Adjustment tariff (PGA) and the Deferral Amortization mechanism are designed to pass through a utility's actual gas costs to its retail customers. The difference between the projected gas cost over a specified period and the actual gas cost incurred for that period is deferred and amortized back to customers (either as a surcharge or a credit) with interest.

Avista's filing proposes to increase annual revenues for the projected cost of gas by approximately $16.5 million (12.1%). Avista proposes to decrease annual revenues associated with the recovery of deferred gas costs by approximately $4.6 million (3.4%). The net effect of Avista's revised PGA\Deferral Amortization tariff filing is a net increase in annual revenues of approximately $11.9 million (8.7%).

The impact of Avista's two tariff filings on a typical residential customer's monthly bill, assuming an average consumption of 70 therms, will be an increase of $5.20 per month (9.46%).

The net effect of the PGA and Deferral Amortization filings on Avista's rates and annual Washington revenues is shown on the following table:

| | Per Therm Change | Annual Rev. Change | Percent Change (rates) |
|---|---|---|---|
| Residential | $.07425 | $7,985,000 | 9.46% |
| Commercial | $.07376 | $3,434,000 | 11.01% |
| Large Gen. Serv. | $.07470 | $389,000 | 12.17% |
| Interruptible | $.07222 | $0 (1) | 12.22% |
| Transportation | $.00106 | $92,000 | 1.99% |
| Total Revenue Impact | | $11,900,000 | 8.7% |

(1) There are no customers on this schedule.

**Discussion:**

Below Staff discusses issues and concerns brought about by this filing.

**Purchased Gas Adjustment (Schedule 156):**

Avista's purchased gas costs result from a single gas supply contract with its affiliate, Avista Energy. The method for determining the price Avista pays Avista Energy for natural gas is set forth in Schedule 163: Natural Gas Benchmark Mechanism.

Avista proposes in this filing that its rates for gas service include a weighted average cost of gas (WACOG) of $.46298 per therm. As a result of this change, natural gas rates would increase by $16.5 million per year. Currently, rates reflect a WACOG of $.36725 per therm. The proposed change is to reflect the expected increased price charged by Avista Energy to Avista under the current Benchmark Mechanism. The cost of natural gas in the market has recently been in the $.44 to $.50 per therm range. Market indications are that gas prices will remain in that range during the next year or two.

Avista had actually calculated a projected WACOG $.48610 per therm (exclusive of any capacity optimization benefits) to support its filing based on forward prices as of the date of the filing. Staff has reviewed Avista's assumptions regarding commodity WACOG and concludes Avista's proposed cost of natural gas of $.46298 per therm is a reasonable estimate to implement given current market conditions.

**Deferred Gas Cost Amortization (Schedule 155):**

Currently, Schedule 155 reflects a surcharge to collect a prior under-recovery of gas costs. Avista proposes in this filing a reduction to the current surcharge which will result in a decrease in annual revenues of approximately $4.6 million (3.4%).

The deferral period subject to review for Avista's proposed changes to the Deferral Amortization rate is the twelve-months ended June 30, 2003. Staff's analysis of this filing has raised concerns in two areas:

1) Whether the PGA and deferral-related rate Avista filed is fair, just and reasonable specifically with regard to basin differentials, off-system sales, and capacity release credits (capacity optimization benefits); and

2) Whether under RCW 80.16.030, Avista has made an adequate showing of reasonableness of the cost to its affiliate, Avista Energy, regarding the gas costs Avista seeks to pass through to ratepayers.

**1. Capacity Optimization Benefits**

Staff has concerns with the level of pipeline capacity benefits credited to Avista during the review period and has requested an analysis of these capacity benefits (and other benefits) realized under the Benchmark Mechanism. Under the Benchmark Mechanism Avista's ratepayers pay 100% of the cost of Avista's pipeline capacity (approx. $15 million annually) that has been transferred to Avista Energy's control. Under the Benchmark Mechanism benefits associated with capacity optimization are intended to flow back to Avista Utilities' customers.

During the deferral period, large differentials developed between the different gas supply basins from which Avista Energy purchases gas supplies utilizing Avista's capacity. These market price differentials created opportunities for entities with rights to firm pipeline capacity, such as Avista had, before it contracted away those rights to Avista Energy, to realize substantial benefits through capacity optimization.

Avista Energy was able to arbitrage the supply basins and benefited economically from doing so. However, according to our preliminary review, Avista, and its customers, did not receive an appropriate level of the benefits associated with these capacity optimization opportunities. Staff's preliminary estimate is that customer's may be entitled to up to an additional $3 million of capacity benefits. This issue arises because under the current Benchmark Mechanism, Avista

Energy bills Avista a fixed percentage of the volumes from each gas supply basin at that basin's price (irrespective of where Avista Energy actually buys the gas). Since Avista Energy may have "used up" the most valuable pipeline capacity to flow gas to the utility (realizing capacity optimization benefits), less valuable pipeline capacity may have been left over for off-system sales and capacity release benefits that flow back to Avista under the Benchmark Mechanism. Staff is concerned that this apparent unintended "crack" in the current Benchmark Mechanism misaligns Avista's and utility customers' interests and raises concerns regarding whether the current Benchmark Mechanism produces rates that are fair, just and reasonable. Absent the Benchmark Mechanism, 100% of these capacity optimization benefits would have flowed back to Avista's ratepayers.

Several data requests are still outstanding as of the date this memorandum that would enable Staff to accurately quantify the benefits to Avista associated with Avista Energy's optimization of pipeline capacity during the deferral period. These data requests involve analyzing, as detailed as on a daily basis, the utilization of Avista's capacity by Avista Energy to verify that pipeline capacity was optimized in the best interest of Avista and its customers.

Accordingly, Staff recommends the tariff be suspended in order to investigate this issue.

**2. Affiliated Interest Issues**

Because the contract between Avista and Avista Energy for gas procurement services is a "management or service contract" under RCW 80.16.010, Avista Energy is an affiliated interest of Avista. Accordingly, Avista is required to prove that its payments to Avista Energy are reasonable. Under RCW 80.16.030, the Commission "shall disallow" the payment if satisfactory proof of reasonableness is not provided.

The Commission has used the lower of cost or market standard in evaluating affiliated interest transactions, as well as non-arm's length transactions between a utility and entities that are not affiliated interests.[1]

Since the deferred costs at issue in this filing arise in the PGA context, this docket is the only opportunity for the Commission to determine whether the payments from Avista to Avista Energy are reasonable. Avista has not provided proof of the net cost to Avista Energy of providing the gas to Avista Utilities.

[1] *E.g., Washington Utilities & Transp. Comm'n, v. Washington Natural Gas Co.,* Docket Nos. UG-911236/UG-911270, Third Supp. Order (Sept. 28, 1992) (applying lower of cost or market price for transactions between Washington Natural Gas Company and its affiliate, Washington Energy Exploration, Inc. ("WEEX"); *Washington Utilities & Transp. Comm'n v. The Washington Water Power Co.,* Cause No. U-82-10 and U-82-11, Second Supp. Order at 26-30 (December 30, 1982) (applying the lower of cost or market price when determining the cost of coal mined and then sold to the Utility by a subsidiary coal mining company named WidCo).

Accordingly, suspension of the tariff is necessary in order to allow more time to properly examine the affiliated interest transactions between Avista and its affiliate, Avista Energy.

<u>Summary and Conclusion</u>:

Staff recommends that the Commission allow the rates to become effective on September 11, 2003, since Avista's current rates do not properly reflect current market prices. Any later adjustment resulting from the capacity optimization issue discussed above can be handled through the deferred gas cost account.

For the reasons stated above, the Commission should suspend the tariff filing in Docket No. UG-031361 and issue a Complaint and Order of Investigation, but allow the rates to become effective on September 11, 2003, on less than statutory notice, on a temporary basis, subject to refund through the deferral account.