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Washington Water Power

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April 25, 1997

Washington Utilities and
Transportation Commission
Attn: Mr. Steve McLellan, Secretary
Olympia, WA 98504

Re: Formation of Avista Internal Holding Company

The intent of this letter is to inform the Commission of the recent organizational changes related to the Washington Water Power's energy marketing line of business. In this letter the Company will outline how it has separated, for both accounting and regulatory purposes, the energy marketing business, including the marketing of electricity, natural gas, oil, etc., from what might be called the traditional retail utility business. This structure is the result of considerable internal discussion and also attempts to anticipate possible concerns of the Commission.

The need and desire to create a different organizational structure was driven by the dramatic changes that have taken place in the wholesale energy business and the Company's need to find earnings growth opportunities in the face of relatively slow growth in its service territory. Company management believes this growth is necessary in order to remain in control of WWP's corporate future.

WWP's native resource capability is approximately 8 million MWH. Even so, total combined retail and wholesale sales were 12 million MWH in 1995 and 19 million MWH in 1996. (see attached Figure 1.) It is important to note that WWP is approximately in load-resource balance with regard to native load, *i.e.*, WWP's existing resources are approximately equal to the total of the Company's native load and contract obligations. The additional sales above 8 million MWH were possible only because of significant additional purchases made by the Company.

The Company expects the energy marketing business to grow even more dramatically in the coming years. To participate successfully in this market the Company's "book of business" will have to be larger, perhaps as much as 50 million MWH. This will necessitate even more purchases, additional capitalization, and potentially operating in the entire continental US, Canada, and Mexico. This business goes well beyond the bounds of a traditional utility serving its native load customers via low risk transactions.

This change did not happen overnight. The Company currently has wholesale energy sales which are contributing million of dollars in margin to offset power costs. Much of this margin is the result of buy/sell activity that had little to do with servicing native load and little reliance on native (rate based) resources. If margin had been lost on these buy/sell arrangements, the Company anticipated it may have been disallowed recovery in any rate proceeding.

The organizational structure shown in Figure 2 was created to allow for full participation in the national and regional energy business and to provide a separation or fire wall between the traditional retail utility business (including existing distribution, transmission, and generation) and the energy trading and power marketing business which is located under a new internal holding company called Avista. The energy trading and power marketing company is called Avista Energy.

WWP will not transfer current wholesale contracts to Avista Holding Company or Avista Energy[1]. All current transactions and the associated margins will remain with the retail business even though the Company believes a good case can be made for transferring some of this business to Avista Energy. The monetary value of these transactions could be considered a goodwill or royalty payment to compensate the retail business for any direct or indirect contribution that the existing system electric resources may have provided in developing these transactions. WWP estimates 1997 margins from long-term transactions of one year or longer to be $37 million of which $19 million could have been legitimately retained by Avista since it resulted from sales that were not dependent on native resources and had little to do with acquiring and optimizing resources to serve native retail customers. Margins for the next five years are estimated to be $130 million of which $79 million could have been retained by Avista.

Avista Energy will also trade natural gas commodity, capacity, and services. Consistent with the electric side of the business, there will be no transfers of any property or business to Avista from the state regulated gas utility side. Like the

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1 . There is one exception we believe is fully justified by the conditions and circumstances surrounding the contract. The contract in question is a purchase of transmission capacity from Portland General Electric for transmission between John Day Dam and COB--100 MW for 1997 and 200 MW for 1998 through 2001. (FERC Docket No. ER97-1512-000.) This purchase contract was signed by WWP at about the time Avista was being legally formed with the full intent, as documented by the January 30, 1997 memo accompanying the contract, of being transferred to Avista for speculative buy/sell arrangements, *i.e.*, wholesale power marketing transactions. The contract is not revenue producing absent added power marketing transactions and can only be resold at cost under FERC rules.

electric side, the Avista gas trading will start without any existing margins that came from WWP Gas, either directly or indirectly.

The retail business will still have its own staff who will operate all Company resources and engage in wholesale energy trading under a risk profile consistent with an emphasis on serving native retail load while at the same time optimizing the resource portfolio servicing native customers. To recognize this areas major purpose, we are calling it the Resource Optimization business. There will still be a need for power brokering activities, short-term and long-term purchase and sales contracts , hedging arrangements, etc. that are consistent with resource optimization and the prudent management of all existing resources and contracts on behalf of retail customers.

However, contrary to Avista Energy, Resource Optimization's energy marketing and trading activities will likely be limited to the WSCC and will likely not involve taking major speculative energy trading "positions" in the wholesale market.

Even though Resource Optimization could find itself in the position of competing with Avista, this should not be a regular occurrence since Resource Optimization will likely be in the market less frequently than Avista and with a different purpose and risk profile. In addition, Avista will be one of more than 50 active participants in the WSCC market and anticipates a market share of less than 5 percent--hardly enough to materially affect Resource Optimization' costs.

The exact level of brokering and trading activity for the Resource Optimization business may well be the subject of future Commission proceedings and the Company expects that it will bear the burden of demonstrating that the level of wholesale and other activity by Resource Optimization is commensurate with what is expected of a utility serving native load customers under the regulation of state commissions. Regardless, the Company intends to maintain an aggressive and dynamic Resource Optimization business.

There are several practices the Company intends to follow in order to separate the retail state regulated side of the business from Avista. Avista will not use existing WWP resources or contracts in promoting or backing up energy sales they may make. Any transactions between Avista and the regulated utility will, of course, be subject to all applicable affiliated transaction rules at both the state and federal level. Avista will not be located in the current WWP office building and will have their own compensation and benefits system. The Company will open the books of Avista Energy, with confidentiality, so that they can be examined by Commission staff. Avista Energy will not obtain any WWP retail customer's energy load until such time as retail wheeling is made generally available either by law or by state commission action.

For accounting purposes, all current energy business will be included in the Company's Commission Basis Reports as will future brokering and trading business resulting from the activities of Resource Optimization. New business generated by Avista Energy will be booked under Avista. The Company will submit a report to the Commission outlining the first year of operation under this new structure.

Avista has already been formed as a legal entity, approved by the WWP Board of Directors, and launched nationally. There has been no change in the legal status of the utility side of the business. Avista capitalization is approximately $300 million, $25 million of which came from WWP retained earnings, the remainder coming primarily from the assets of Pentzer, another Company subsidiary that has been moved under Avista. The former Energy Solutions business will be called Avista Advantage.

Sincerely,

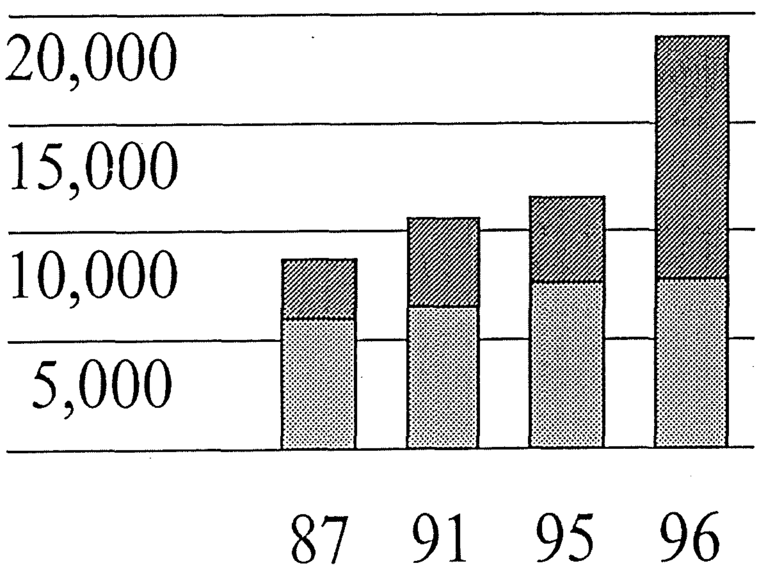
Paul A. Redmond
Chairman of the Board
and Chief Executive Officer

cc: Commissioner Sharon Nelson
Commissioner Richard Hemstad
Commissioner William R. Gillis

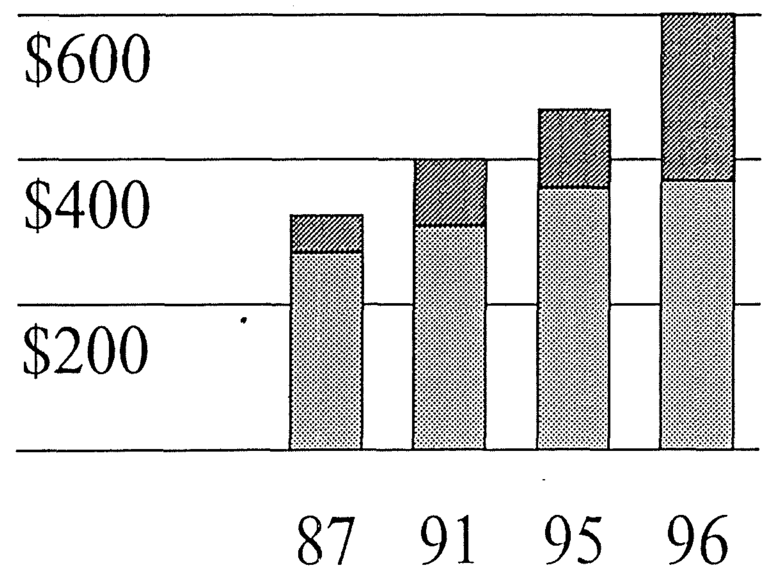
Electric Business

Wholesale
Retail

Kwh Sales (millions)



Electric Revenues (millions)



WWP Washington Water Power

Corporate Structure