Exhibit No. _____ (MPP-1T)
Docket No. UG-021584
Witness: Michael P. Parvinen

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	DOCKET NO. UG-021584

TESTIMONY OF

MICHAEL P. PARVINEN

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

July 18, 2003

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Q. WOULD YOU STATE YOUR NAME AND BUSINESS ADDRESS?

A. My name is Michael P. Parvinen. My business address is 1300 S. Evergreen Park Dr. S.W., P.O. Box 47250, Olympia, Washington 98504-7250. My e-mail address is mparvine@wutc.wa.gov.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am a Regulatory Analyst employed by the Washington Utilities and Transportation Commission.

Q. FOR HOW LONG HAVE YOU BEEN SO EMPLOYED?

A. Since January 1987.

Q. WHAT ARE YOUR EDUCATIONAL AND PROFESSIONAL QUALIFICATIONS?

A. I graduated from Montana College of Mineral Science and Technology in May 1986, and received a Bachelor of Science degree in business administration with a major in accounting. I have provided testimony before the Commission in the following dockets: Docket Nos. UE-011570/UG-011571 – Puget Sound Energy; Docket No. UE-010395 – Avista Corporation; Docket Nos. UE-991606/UG-991607

– Avista Corporation; Docket No. UG-931405 - Washington Natural Gas Company; Docket No. UG-920840 - Washington Natural Gas Company; Docket No. UG-911246 - Cascade Natural Gas Corporation; Docket No. UE-900093 - The Washington Water Power Company; Docket No. U-89-2688 - Puget Sound Power & Light Company; Docket No. D-2576 - Bremerton-Kitsap Airporter, Inc.; and Docket No. U-88-2294-T - Richardson Water Companies. I have also analyzed or assisted in the analyses of numerous other transportation and utility rate filings. I attended the Seventh Annual Western Utility Rate Seminar in 1987, and the 1988 Annual Regulatory Studies Program, sponsored by the National Association of Regulatory Utility Commissioners (NARUC).

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I present Staff's evaluation and recommendations regarding Avista Corporation's proposed Natural Gas Benchmark Mechanism (Benchmark Mechanism or Mechanism). In my testimony, I refer to Avista Corporation as "Avista Corp.," "Utility," or "Company."

A. DO YOU SPONSOR ANY EXHIBITS?

A. Yes, I sponsor exhibits Exhibit Nos. _____ (MPP-2) through _____ (MPP-12).

I. SUMMARY AND STATEMENT OF RECOMMENDATIONS

Q. PLEASE SUMMARIZE STAFF'S CONCLUSIONS BASED ON ITS ANALYSIS OF AVISTA'S PROPOSED BENCHMARK MECHANISM.

A. There are four principal conclusions that lead to Staff's recommendations:

1) The Utility could itself adopt the same strategy for gas procurement and capacity management functions contained in the Benchmark Mechanism, and provide more benefits to customers than are proposed by Avista Corp.

2) The Benchmark Mechanism requires Avista Energy, a subsidiary of Avista Corp., to provide the gas procurement and capacity management functions for the Utility. This is not an arm's length transaction. Therefore, it should be evaluated using the "lower of cost or market" standard. Such an evaluation cannot be made because of the way the Mechanism is managed and operated.

3) The Benchmark Mechanism presents a fundamental change in policy from the Purchase Gas Adjustment (PGA) Mechanism the Commission has used for gas utilities in this state. No longer would the PGA be based on actual gas costs.

4) The Benchmark Mechanism is not consistent with the Commission's Policy Statement on purchased gas incentive mechanisms.

Q. PLEASE STATE STAFF'S RECOMMENDATIONS REGARDING THE BENCHMARK MECHANISM.

A. Staff recommends that the gas procurement and capacity management functions revert back to the Utility. By doing so, the benefits from the gas procurement strategy can be directly measured and passed on to customers. Because that strategy would no longer be stated in a tariff, the Utility could immediately adapt the strategy to changes in the market, rather than use the tariff process. Staff's recommendation resolves the problems associated with the non-arm's length transaction between Avista Corp. and its subsidiary, Avista Energy. Actual gas costs would be recovered from customers through the PGA process.

If the Commission decides the Mechanism should continue in some form, I provide three alternatives at the end of my testimony for Commission consideration.

II. BACKGROUND

Q. WOULD YOU PROVIDE SOME BACKGROUND INFORMATION THAT WILL ASSIST THE COMMISSION TO BETTER UNDERSTAND THE CONTEXT OF THIS CASE?

A. Yes. Below I provide the following background information: A) The nature and history of Purchase Gas Adjustment (PGA) Mechanisms; B) A description of how gas flows to serve Avista Corp.'s customers; C) Procedural history of the Benchmark Mechanism; D) A description of the Benchmark Mechanism; and E) A description of the additional changes Avista Corp. proposes in its direct testimony.

A. The Nature and History of the Purchased Gas Adjustment (PGA) Mechanism

Q. PLEASE DESCRIBE THE NATURE AND BRIEF HISTORY OF THE PGA MECHANISM.

A. Purchased Gas Adjustment tariffs were originally put in place to track the actual cost of gas charged to the utility. In Avista Corp.'s case, this was gas purchased from Northwest Pipeline Corporation (Northwest Pipeline), the only wholesaler of natural gas in Avista's service territory at the time. The cost of the gas was established in a wholesale tariff approved by federal regulators. At that time, Northwest Pipeline provided a bundled gas service that included both commodity and capacity at tariffed rates.

When the wholesale tariff rates changed, the Local Distribution

Companies (LDC), such as Avista Corp., would track the changes in those rates by filing a change in the PGA tariff on file with this Commission.

When interstate pipeline services were unbundled and LDCs became responsible for their own gas supply acquisitions, PGAs remained in use to track the actual cost of gas supply and capacity.

The fundamental change made by the Benchmark Mechanism is that while the Utility still pays a price to Avista Energy, that price is not based on Avista Energy's cost to serve the Utility.

B. A Description of How Gas Flows to Serve Avista Corp.'s Customers

Q. HOW DOES GAS FLOW TO SERVE AVISTA CORP.'S CUSTOMERS' NEEDS?

A. Avista Corp. has the advantage of having access to three natural gas supply basins, plus two pipelines, and the Jackson Prairie storage facility. These are shown on the map that I sponsor as my Exhibit No. _____ (MPP-2).

As Exhibit No. _____ (MPP-2) reflects, Avista is able to purchase and transport gas from three distinct locations, called basins, in order to serve Avista Corp.'s customers: AECO (gas fields located in Alberta, Canada), Sumas (gas fields located in British Columbia, Canada), and Rockies (domestic gas primarily

from gas fields located in southern mid-western states). Each of these basins is an active trading hub or market.

Gas is transported from these basins to Avista Corp.'s service territory by two pipelines, with which the Utility has long-term contracts for pipeline capacity. The Northwest Pipeline runs from Sumas, Washington to the Rockies. This pipeline is multi-directional, meaning that gas can be injected at each end of the pipeline. The other pipeline is the Pacific Gas Transmission (PGT) Pipeline, which runs from AECO to California, and intersects Northwest Pipeline at Stanfield, Oregon.

In addition, Avista Corp. is a one-third owner of the Jackson Prairie (JP) gas storage facility located along the Northwest Pipeline near Chehalis, Washington. JP provides many benefits to the Utility besides summer/winter price differentials. For example, JP can be used to balance the Utility's gas loads on a daily basis. It gives the Utility a degree of price and volume flexibility, as well as peaking flexibility. In other words, Avista Corp. is able to use JP at times when the market for gas is not favorable, or to meet the Utility's peaking needs. JP storage capacity includes firm pipeline capacity to transport gas from JP to Avista's service territory, using the Northwest Pipeline.

C. Procedural History of the Benchmark Mechanism

Q. PLEASE PROVIDE A PROCEDURAL HISTORY OF THE BENCHMARK MECHANISM.

A. Avista Corp.'s Benchmark Mechanism was first implemented in September 1999, in Docket No. UG-990614, with a termination date of March 31, 2002. The Mechanism was modified in Docket No. UG-011500, and a one-year extension (through March 31, 2003) was approved.

The Company's tariff filing in the current docket makes minor modifications to the Mechanism, and would extend the termination date two years, to March 31, 2005.

The Company's direct testimony proposes additional modifications, in the Company's attempt to address certain concerns Staff identified at the Commission's January 29, 2003, Open Meeting. The Company now proposes to extend the termination date of the Mechanism to March 31, 2007.

D. A Description of the Benchmark Mechanism

Q. PLEASE DESCRIBE THE BENCHMARK MECHANISM.

A. There are three versions of the Benchmark Mechanism currently at issue: the

version currently in effect; the version that was suspended in this docket; and the version Avista is proposing in its direct testimony. However, each of these versions is fundamentally the same. Each contains the following major components: the Commodity Component; the Jackson Prairie (JP) Storage Component; and the Capacity Release and Off-System Sales Component. I describe each Component in detail below, as it relates to the current and suspended versions of the Mechanism.

Commodity Component: Under the Commodity Component, gas volumes are purchased under a diversified portfolio approach that is intended to provide a balance between supply cost and rate stability. The Commodity Component is based on a "tiered" approach, in which Avista's annual loads are separated into four tiers. The following table shows the four tiers involved:

Table 1

	% of Load Obligation	**How Priced**
Tier 1	50%	Fixed price/hedged
Tier 2	46.5%	First of Month (FOM Index
Tier 3	3%	Gas Daily Index
Tier 4	.4%	Less of Gas Daily Index, JP Storage, or LNG
Total	100%	

Tier 1 (about 50 percent of the portfolio) is the baseload. These are volumes that would occur given any weather situation. The price of this Tier 1 load is fixed. 50 percent of the estimated annual load is hedged with a combination of fixed price supply contracts and storage gas under the JP synthetic schedule (the JP synthetic schedule is described later under the Storage Component of the Mechanism).

Tier 2 (about 46.6 percent of the portfolio) consists of average volumes for each particular month based on historical data. Tier 2 gas is priced using a first of the month (FOM) index. For daily volumes that vary between the average and minimum of the range and the average and maximum range for Tier 2 (+/-10 percent of average), Avista Energy takes the risk for either the purchase or sale of gas at FOM index prices.

The FOM index is published in the "Canadian Gas Price Reporter" and in the "Inside FERC Gas Market Report."

Tier 3 (about 3 percent of the portfolio) consists of volumes above the average range. Tier 3 gas purchases occur infrequently and for short periods of time. Tier 3 gas volumes are priced using the Gas Daily Index, or if it is economical to do so, gas is withdrawn from storage.

The Gas Daily Index price is the midpoint of the "Gas Daily" prices as

reported in McGraw Hill's "Gas Daily."

Tier 4 (about .4 percent of the portfolio) consists of peaking volumes. Peaking is also required infrequently, and is usually weather-driven. Peaking services are provided by either JP storage, or the Plymouth Liquefied Natural Gas (LNG) facility, if economically feasible. Any withdrawals from JP storage will adjust the remaining synthetic injection and withdrawal schedule.

The "tiered" approach to gas supply acquisition is intended to provide customers with price stability through use of hedging purchases, as well as the benefits of market-priced gas. The Commodity Component is also intended to limit the amount of risk associated with daily load variations.

JP Storage Component: The Jackson Prairie (JP) Storage Component is intended to provide additional savings from summer/winter price differentials as well as other operational benefits. Avista has developed a synthetic (i.e., predetermined) injection and withdrawal schedule based on historical injection and withdrawal cycles, modified to give customers the summer/winter differential based on 100 percent utilization of a full cycle. A "full cycle" is defined as injection until full and withdrawal until empty.

What this means is that gas will be injected into storage in the summer months when gas is typically cheaper, and then withdrawn in the winter to serve

the Utility's loads at a time when gas is typically more expensive. JP's injection and withdrawal schedule conforms to Northwest Pipeline's tariffs that require the facility to be 35 percent full by June 30th, 80 percent full by August 31st, and 100 percent full by September 30.

JP storage can also be used in Tier 4, if it is economical to do so. The remaining JP synthetic schedule would then be adjusted based on volumes withdrawn to meet the needs of Tier 4.

Pipeline Capacity Release/Off-System Sales Component: The Pipeline Capacity Release and Off-System Sales Component is intended to derive benefits from optimizing pipeline capacity reserved for the Utility's customers. This component is designed to credit customers with 100 percent of the benefits of capacity release/off-system sales activity up to $5 Million, and a 50/50 sharing between Utility customers and Avista Energy above the $5 million level.

E. Description of the Changes Avista Corp. Proposes in its Tariff and in its Direct Testimony

Q. PLEASE DESCRIBE THE ADDITIONAL CHANGES TO THE MECHANISM AVISTA CORP. IS PROPOSING IN THE TARIFF IT FILED TO INITIATE THIS CASE.

A. In the suspended version of the Mechanism, the Company proposes to expand the use of storage to include Tier 3 purchases (3 percent of the portfolio), and to create an allegedly more defined audit trail for gas supply purchases.

Q. WHY DID THE COMPANY OFFER ADDITIONAL CHANGES TO THE MECAHNISM IN ITS DIRECT TESTIMONY?

A. The Company proposed changes in its direct case to attempt to address concerns identified by Staff in its January 29, 2003, Open Meeting memo to the Commission.

Q. HAVE YOU INCLUDED AS AN EXHIBIT STAFF'S JANUARY 29, 2003, OPEN MEETING MEMO TO THE COMMISSION?

A. Yes. A true and correct copy of that memo is included in my Exhibit No. _____ (MPP-3).

Q. DO THE CHANGES TO THE BENCHMARK MECHANISM PROPOSED BY THE COMPANY IN ITS DIRECT CASE ALLEVIATE THE CONCERNS STAFF ADDRESSED IN THAT MEMO?

A. No. The Staff's main concerns were not addressed in the Company's direct case.

These concerns relate to:

1) The inability to identify or audit Avista Energy's actual cost to serve the Utility;

2) The inability to apply the "lower of cost or market" standard to the non-arm's length transaction between Avista Corp. and Avista Energy;

3) The use of a tariff to prescribe the Utility's gas procurement strategy may constitute pre-approval of management's gas purchase decisions.

I will address these points later in my testimony, as well as the implications of the Benchmark Mechanism on the PGA process and how the Mechanism relates to the Commission's May 1997 Policy Statement on gas incentive mechanisms.

Q. WHAT CHANGES TO THE MECHANISM DOES THE COMPANY PROPOSE IN ITS DIRECT CASE?

A. The Company proposes changes to each of the three components (Commodity, Storage, Off-system/Capacity Release Revenue), as follows.

Commodity. Avista now proposes to modify the Commodity component to include only three tiers, instead of four. Tier 1 is still 50 percent of the expected average monthly load at fixed price gas, including hedged gas and

storage gas. Tier 2 gas is priced at first of the month (FOM) indexes applied to the remaining 50 percent of the expected average monthly load. Tier 3 includes daily deviations between actual load and average expected daily load. Tier 3 volumes, either purchases or sales, will be priced at Avista Energy's average actual price by basin, if Avista Energy actually purchases or sells at the basin on that day. Otherwise, these transactions are priced using the Gas Daily index. The difference between the Gas Daily Index price and the FOM Index price will now be shared 80 percent to customers/20 percent to Avista Energy. Storage may also be considered in Tier 3, if appropriate.

Storage. This component is essentially the same as Avista Corp.'s suspended Benchmark proposal, except that Avista Energy can elect to inject gas outside the terms of the synthetic schedule, if the price is appropriate. Customers will share any gains or losses from storage transactions, 80 percent to customers/20 percent to Avista Energy.

Capacity Release/Off-System Sales. This component is essentially the same as Avista's suspended proposal, except that instead of the $5 million in the suspended version, the Company proposes that only the first $3 million in capacity release/off-system sales revenue be guaranteed, with revenues beyond the $3 million shared 80 percent to customers/20 percent to Avista Energy.

III. DISCUSSION OF ISSUES

A. The non-arm's length transaction between the Utility and Avista Energy

Q. PLEASE DESCRIBE THE RELATIONSHIP BETWEEN AVISTA CORP. AND AVISTA ENERGY, INC.

A. Avista Energy, Inc. is a wholly owned subsidiary of Avista Capital, Inc. Avista Capital, Inc. is a wholly owned subsidiary of Avista Corp. Avista Corp. operates the regulated utility operations under the name Avista Utilities. Mr. Gary Ely is the President of both Avista Corp. and Avista Energy, Inc.

The gas procurement and capacity management functions that Avista Energy performs for Avista Corp. are performed pursuant to an agency agreement dated August 26, 1999, between the two companies. A true and correct copy of that contract is my Exhibit No. _____ (MPP-4).

Q. IS THE AGREEMENT BETWEEN AVISTA ENERGY AND THE UTILITY FOR GAS PROCUREMENT AND CAPACITY MANAGEMENT FUNCTIONS AN "ARM'S LENGTH" TRANSACTION?

A. No. Avista Corp. and Avista Energy do not operate independently from one another under separate and independent management and ownership.

Accordingly, the transactions between the two are not at arm's length.

Q. IS THE AGREEMENT BETWEEN AVISTA ENERGY AND AVISTA CORP. FOR GAS PROCUREMENT AND CAPACITY MANAGEMENT SERVICES AN AFFILIATED TRANSACTION?

A. I cannot respond to the extent this question calls for a legal conclusion. I can respond based on my understanding. It is my understanding that since Avista Energy does not own any of Avista Corp.'s voting securities, Avista Energy does not meet the ownership requirements of RCW 80.16.010. However, "management or service contracts" are also defined as affiliated interests under RCW 80.16.010. It is my understanding that the contract between Avista Energy and Avista Utilities is a management or service contract. This is supported by the "Recitals" on page 1 of the contract in my Exhibit No. _____ (MPP-4), the Agreement between Avista Energy and Avista Corp.:

> WHEREAS, [Avista] Corp. desires [Avista] Energy to provide management services for its natural gas supply, transportation and natural gas storage; and
>
> WHEREAS, [Avista] Energy desires to provide these management services.

Q. HOW DOES A NON-ARM'S LENGTH TRANSACTION AFFECT THE BENCHMARK MECHANISM?

A. It is the single most problematic aspect of the Mechanism. In a non-arm's length transaction, a lower of cost or market standard should apply to evaluate the transactions. As I explain later, that standard cannot be applied because of the way the Mechanism is managed and operated.

Q. HAS THE COMMISSION APPLIED THE LOWER OF COST OR MARKET STANDARD IN EVALUATING AFFILIATED INTEREST TRANSACTIONS?

A. Yes. The most recent Commission order of which I am aware is in *Washington Utilities & Transp. Comm'n, v. Washington Natural Gas Co.,* Docket Nos. UG-911236/UG-911270, Third Supp. Order (Sept. 28, 1992), involving the former Washington Natural Gas Company and its affiliate, Washington Energy Exploration, Inc. ("WEEX"). On page 6 of that Order the Commission stated:

> The Commission has repriced affiliated transactions at the affiliate's cost for the good or service, including a fair return on investment. Here, however, the average domestic market price is substantially lower than WEEX' cost including a fair return. The ratepayers should not be required to support a company's purchases from an affiliate at a price greater than the company would pay for comparable supply on an open market.

Q. HAS THE COMMISSION APPLIED THE LOWER OF COST OR MARKET STANDARD FOR NON-ARM'S LENGTH TRANSACTIONS OUTSIDE THE AFFILIATED INTEREST CONTEXT?

A. Yes. For example, the Commission applied the lower of cost or market standard when determining the cost of coal mined and then sold to the Utility by a coal mining company named WidCo. *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).

WidCo was a wholly owned subsidiary of Washington Water Power Company, now known as Avista Corp. The coal was used by the Utility to fuel its share of output from the Centralia Steam Plant.

Q. HAS THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS (NARUC) ADOPTED THE LOWER OF COST OR MARKET STANDARD FOR NON-ARM'S LENGTH TRANSACTIONS INVOLVING ENERGY UTILITIES?

A. Yes. On July 23, 1999, the NARUC Board of Directors adopted a "Resolution Regarding Cost Allocation Guidelines for the Energy Industry," which includes an Attachment. A true and correct copy of the Resolution and the Attachment is

my Exhibit No. _____ (MPP-5).

In the Attachment to that Resolution, NARUC adopted the following policy, among others:

> Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.

Exhibit No. _____ (MPP-5) page 6 of 7, item D.2.

Q. HOW DOES NARUC DEFINE THE TERM "AFFILIATES" FOR PURPOSES OF THIS RESOLUTION?

A. NARUC defines the term "affiliates" as "companies that are related to each other due to common ownership or control." Exhibit No. _____ (MPP-5) at page 4 of 7. This would cover Avista Corp. and Avista Energy because they have common ownership or control.

B. The inability to measure Avista Energy's cost to serve Avista Corp., or the market price of the services rendered

Q. CAN THE COMMISSION DETERMINE IF THE SERVICES PROVIDED BY AVISTA ENERGY TO AVISTA CORP. ARE AT MARKET PRICES?

A. No.

Q. HOW COULD THE COMMISSION DETERMINE IF THE SERVICES PROVIDED BY AVISTA ENERGY ARE AT MARKET RATES?

A. The best way is using a Request For Proposal (RFP) process whereby competitive bids are evaluated to determine the best price for the services rendered.

Q. HAS THE COMPANY ISSUED A REQUEST FOR PROPOSAL ON THE FULL SET OF SERVICES PERFORMED UNDER THE MECHANISM?

A. No.

Q. CAN THE COMMISSION DETERMINE THAT THE GAS IS PROVIDED TO THE UTILITY AT AVISTA ENERGY'S COSTS?

A. No.

Q. PLEASE EXPLAIN WHY NOT.

A. Avista Energy operates on a total gas supply portfolio basis. The Utility's load is less than 10 percent of the total load managed by Avista Energy. Avista Energy looks at its total daily load requirements and its gas portfolio to meet those total

requirements, and then enters into daily purchases or sales as necessary to balance its total daily load requirements. Once this is done, Avista Energy devotes its resources to entering into transactions to redistribute gas supplies from the most economical basin (gas field location or trading hub) and still maintain overall load balance, while taking into account the availability of transportation capacity. Gas within Avista Energy's portfolio (including the supplies ear-marked as the Utility's) can be bought and sold at the same point, or delivered to points on or off the Utility's distribution system. This process can occur many times during the course of a day, depending on how market prices change throughout the day. All of these activities affect the average cost of each therm used to serve the Utility's customers.

The Company provided a description of Avista Energy's daily operations as a response to Staff Data Request No. 5.

Q. HAVE YOU INCLUDED AS AN EXHIBIT THE COMPANY'S RESPONSE TO STAFF DATA REQUEST NO. 5?

A. Yes. Included in my Exhibit No. _____ (MPP-6) is a true and correct copy of the Company's response to Staff Data Request No. 5.

Q. DOES THIS MANNER OF DAILY OPERATION AND THE INABILITY TO INDENTIFY ACTUAL COSTS INVOLVE ALL TIERS OF COMMODITY GAS?

A. Yes.

Q. HOW DO AVISTA ENERGY'S OPERATING PROCEDURES RESULT IN THE INABILITY TO IDENTIFY THE ACTUAL COST OF THE GAS SERVING THE UTILITY'S CUSTOMERS?

A. Because Avista Energy is using a total portfolio approach for gas supply management, individual therms cannot be tracked. Without the ability to track therms as well as the associated costs and revenues, Avista Energy cannot identify its own actual cost of gas or the cost of gas to serve the Utility.

Q. IF AVISTA ENERGY CANNOT TRACK INDIVIDUAL THERMS, IS AVISTA ENERGY'S ACTUAL COST THE AVERAGE COST OF ALL THE DAILY TRANSACTIONS?

A. No. Avista Energy does not operate in a manner that permits it to compute even an average cost of gas each day. That is because Avista Energy uses a "mark to market" approach. Under that approach, Avista Energy evaluates the market price in each of the basins to determine which transaction to enter into. The

"mark to market" methodology does not permit Avista Energy to calculate its actual cost of gas for the therms it sells to Avista Corp.

Q. WHY DOESN'T AVISTA ENERGY TRACK ITS ACTUAL REVENUES AND COSTS BY THERM?

A. Under a "mark to market" methodology, Avista Energy compares the value of its daily positions to the market in order to evaluate its daily profits and losses. The market values of these daily positions are evaluated in accordance with Avista Energy's Risk Management Policies. Tracking actual revenues and costs is not relevant to that methodology.

Q. HAS THE COMPANY PROVIDED ANY INFORMATION EXPLAINING HOW AVISTA ENERGY USES THE "MARK TO MARKET" METHODOLOGY?

A. Yes. I have included as my Exhibit No. _____ (MPP-7) the Company's response to Staff Data Request No. 80 and the Company's response to Public Council Data Request No. 10.

The Company's response to Public Counsel's Data Request No. 10 shows that Avista Energy does not track a weighted average cost of gas because of Avista Energy's use of "mark to market" accounting practices. The Company's

response to Staff Data Request No. 80 briefly describes how the "mark to market" approach applies to Avista Energy.

Q. IS AVISTA ENERGY'S INABILITY TO IDENTIFY THE ACTUAL COST TO SERVE THE UTILITY A SUBSTANTIAL DEPARTURE FROM THE TRADITIONAL PGA PROCESS OR METHODOLOGY?

A. Yes. PGAs have always been based on actual cost. By allowing the Benchmark Mechanism to continue, the Commission would be allowing the Utility to pass charges on to customers through the PGA process that are not based on actual cost, but rather based on a pricing formula described in the Mechanism.

Q. BESIDES THE OVERALL OPERATIOIN OF AVISTA CORP.'S PORTFOLIO (WHICH INCLUDES ALL TIERS), ARE THERE SPECIFIC COMPONENTS WITHIN THE MECHANISM THAT ARE NOT BASED ON ACTUAL COSTS, BUT RATHER A PRICING FORMULA?

A. Yes. The daily transactions involving Tier 3 gas are one example.

Q. CAN YOU GIVE EXAMPLES OF HOW A TIER 3 TRANSACTION IS NOT BASED ON AVISTA ENERGY'S ACTUAL COSTS?

A. Yes. First, assume the Utility required 5000 therms of natural gas at the Sumas basin in order to balance its daily load. The Utility would pay for those 5000 therms at Avista Energy's average actual purchase price at the Sumas basin on that day, assuming Avista Energy actually purchased any volumes from that basin. However, because Avista Energy operates on a total portfolio basis, Avista Energy's total portfolio may either be in balance, or may not need any gas at all from Sumas.

In the case that Avista Energy's total portfolio was in balance, or did not need gas from Sumas, the 5000 therms that the Utility needed would be priced at the Gas Daily Index price for the Sumas basin. The logic here appears to be that in this situation, some other customers had excess gas of 5000 therms, and that Avista Energy sold that gas at the daily price and repurchased it at the daily price for the Utility. However, in this example, the actual cost of the 5000 therms is neither the daily price nor the index price. The actual cost is Avista Energy's imbedded cost of the 5000 therms of excess from another customer or supply contract within Avista Energy's portfolio. That actual cost of gas is not tracked through to the Utility's cost of gas.

Another example is if the Utility had excess volumes, but Avista Energy's system was in balance. In this situation, the Mechanism provides the Utility a

credit for the sale of that excess gas at the Gas Daily Index price, not at the actual price paid by the persons who actually consumed that gas. Here again, the Mechanism does not track the actual cost of gas.

Q. IS THE INABLITY TO AUDIT OR DETERMINE THE ACTUAL COST OF THE GAS THAT IS PROVIDED TO SERVE AVISTA CORP.'S CUSTOMERS NEEDS LIMITED TO TIER 3 PURCHASES?

A. No. It applies to all Tiers.

Q. ARE THERE OTHER EXAMPLES OF COMPONENTS WITHIN THE MECHANISM THAT ARE TIED TO CALCULATIONS AND NOT ACTUAL COSTS?

A. Yes. Another example relates to off-system sales. Whenever the Utility's capacity is used to transport gas to somewhere other than the Utility's distribution system, the Utility receives a credit for the value of the capacity used. The credit is based on the differential in market or index price between the receipt point and the delivery point on that day. This sort of transaction is not based on the actual cost of the gas plus variable transportation costs, compared to the revenue for the gas plus variable transportation costs.

Q. WHY ARE THESE TYPES OF TRANSACTIONS NOT BASED ON ACTUAL REVENUES AND COSTS?

A. Avista Energy cannot identify the actual cost of gas being sold in off-system transactions because of its operating practices and procedures. As a result, Avista Energy uses a calculation to estimate the value of the pipeline segment for which the Utility has capacity, regardless of the actual revenue or costs of the complete transaction. Avista has indicated that it may be possible to track the actual revenue from a transaction, but actual costs are not identifiable. Avista Energy doesn't look at a transaction and say "we are selling this amount of gas purchased at Y basin for $X1 amount and selling the gas at Z basin for $X2." Instead, Avista Energy looks at the market value of the gas at the origination point compared to the market value of the gas at the destination point.

Q. ARE THE COSTS THAT AVISTA ENERGY CHARGES TO THE UTILITY FULLY AUDITABLE AND COST-BASED?

A. No. In its testimony, Avista states that the gas supply components in the Mechanism, particularly Tier 1 and Tier 2 gas acquisitions, are entered into by Avista Energy and directly assigned to the Utility. Avista also states that these transactions are fully auditable and they cover 100 percent of the Utility's

average monthly loads. (See, e.g. Exhibit No. _____ (KON-1T), page 5, line 17, pages 12-13, and Exhibit No. _____ (RHG-1T), pages 16-21, and Exhibit no. _____ (MED-1T), page 6).

However, these gas acquisitions are only the starting point for Avista Energy's daily management of its total gas portfolio, as I have previously described. Moreover, the Utility's gas supply needs are only a small portion of Avista Energy's overall purchases and sales. As such, the Utility's gas portfolio, pipeline capacity rights, and storage capability, are incorporated into Avista Energy's total portfolio, and are managed as such. It is not possible to audit all transactions that ultimately involve serving Avista Corp. specifically, as opposed to the total portfolio.

Finally, Avista Energy's use of the "mark to market" approach shifts the focus to managing the value of Avista Energy's overall positions on any given day, versus managing to maximize Utility benefits. As a result, Avista Energy's charges to the Utility cannot be audited to the cost source, because they are not cost-based.

Q. CAN YOU ELABORATE ON HOW AVISTA ENERGY OPERATES DIFFERENTLY FROM A UTILITY ON ANY GIVEN DAY?

A. If Avista Energy's total portfolio is long or short on any given day, its focus is to get into balance by selling or buying gas supplies. It then optimizes its resources based on market value. It sells for the highest price it can and at the highest price basin, if transportation is available to move the gas to the location offering the highest price.

Q. HOW DOES THIS COMPARE TO HOW A UTILITY WOULD OPERATE?

A. The Utility would also need to get into balance on a daily basis, either by buying or selling gas or using storage. It would also optimize its system based on the market values. However, a Utility would compare market value to embedded costs, as opposed to Avista Energy's comparison of market value between basins.

Q. HOW ARE THESE APPROACHES MATERIALLY DIFFERENT?

A. Simply put, one is cost-based (Utility) and the other is market-based (Avista Energy). Because Avista Energy looks at all transactions it enters into on a "mark to market" basis, regardless of what the embedded costs actually are, Avista Energy cannot determine how much it costs to serve the Utility.

C. The Value of the Utility Itself Performing the Gas Procurement Strategy

Q. CAN THE UTILITY USE THE GAS PROCUREMENT STRATEGY DESCRIBED IN THE BENCHMARK MECHANISM WITHOUT USING AVISTA ENERGY?

A. Yes.

Q. IN MR. GRUBER'S DIRECT TESTIMONY, EXHIBIT NO. ___ (RGH-1T), AT PAGE 6, THE COMPANY STATES THAT IT WOULD COST THE UTILITY AN ADDITIONAL $2.6 MILLION TO BRING THE GAS PROCUREMENT FUNCTIONS BACK TO THE UTILITY. DO YOU AGREE WITH THIS CALCULATION?

A. No.

Q. HAVE YOU PREPARED EXHIBITS SHOWING THE APPROPRIATE CALCULATION?

A. Yes. I prepared my Exhibit Nos. _____ (MPP-8) and _____ (MPP-9C) to show the appropriate calculation. Exhibit No. _____ (MPP-8) is in the same format as Mr. Gruber's table on page 7 of his direct testimony. Exhibit No. _____ (MPP-9C) provides certain calculations that support the figures in my Exhibit No. _____

(MPP-8).

Q. WHAT DOES THE APPROPRIATE CALCULATION SHOW?

A. The appropriate calculation shows net benefits of at least $1,615,655, were the Utility once again to perform the gas procurement function. This can be demonstrated by comparing the figures in the table on page 7 of Mr. Gruber's direct testimony, Exhibit No. _____ (RHG-1T), with the table in my Exhibit No. _____ (MPP-8), entitled "Estimated Annual Incremental Benefits Associated With Natural Gas Procurement Managed by the Utility vs. Avista Energy."

Q. PLEASE DESCRIBE EACH OF THE ADJUSTMENTS YOU MADE TO THE COMPANY'S CALCULATION.

A. The first adjustment is on line 4 of my Exhibit No. _____ (MPP_8), entitled "Currency." The Company assumes this component is a cost item based on an estimated rate of 1 cent per decatherm. In fact, as a matter of logic, this item should be zero because there should be an equal chance of currency changes, both up and down.

The second adjustment is to line 5, entitled "Load Volatility (1)." The Company's calculation nets estimated benefits from basin optimizations with

estimated net costs associated with Tier 3 purchases and sales. There are two problems with the Company's calculation.

First, the Company's calculation of the daily swing around the average assumes all volatility is purchased and sold at the Gas Daily Index. This creates a net cost, as compared to the FOM index. The Company's calculation ignores their ability to use storage to mitigate daily volume volatility. Yet, the Mechanism allows for daily withdrawals of storage, as well as injections into storage. On certain days, when actual load is less than the average expected load, the excess gas can be injected into storage at the purchase price based on the FOM index. The excess gas can later be withdrawn on days when actual load requirements are above the average expected load, at the same price as when it was injected into storage. The result is the Tier 3 load volatility would be met at FOM index pricing, resulting in no additional cost for this component beyond the FOM index price.

Q. ARE THERE VARIABLES THAT COULD AFFECT THE CALCULATION OF LOAD VOLATILITY AND HOW IT IS MANAGED?

A. Yes. Because every day of every month will not be average, in some months there will be no space in storage to physically inject gas. Likewise, there will be

times when stored gas will be unavailable for withdrawal. On the other hand, there will also be times when gas will not be injected because it can be sold at a higher price than the FOM index price. At other times, gas will not be withdrawn from storage to meet the daily load volatility because it can be bought more cheaply than the FOM index price.

In my analysis, I assume these "positive" situations can offset the times when physical constraints on storage create an actual cost beyond the FOM index. In short, Avista's calculations fail to take account the ability to use storage daily, and the result is an overstatement of cost, and an understatement of benefits, to the Utility.

Staff's calculation of this element is shown on line 3 of Exhibit No. _____ (MPP-9C).

Q. WHAT IS THE SECOND ISSUE REGARDING THE COMPANY'S CALCULATION OF THE NUMBER FOR THE "LOAD VOLATILITY (1)" LINE?

A. Avista's "Load Volatility" line on page 7 of Mr. Gruber's direct testimony includes the additional costs and benefits that the Utility would be responsible for, if the gas procurement function were to revert back to the Utility. The Company's calculation shows that Avista Energy's 20 percent share of the net

costs/benefits under the Mechanism become part of the Utility's costs/benefits if the Mechanism reverts back to the Utility. However, the Company's calculation does not include the benefits associated with Winter Summer Differential, Storage Peaking Benefits, and Capacity Release/Off-System Sales Revenues that would go to the Utility, rather than Avista Energy, under the 20 percent sharing component.

These benefits should be included. I have included them on lines 4, 5, & 7 of Exhibit No. _____ (MPP-9C).

The sum total of each of Staff's adjustments relating to Load Volatility is ($1,759,855), as shown on line 10 of Exhibit No. _____ (MPP-9C). This total figure (which is not confidential) is brought forward to line 5 ("Load Volatility") in my Exhibit No. _____ (MPP-8).

Q. ARE THERE OTHER LINES ON YOUR EXHIBIT NO. _____ (MPP-8) THAT DIFFER FROM THE COMPANY'S PRESENTATION?

A. Yes. Line 6, entitled "Estimated Loss of Transportation Benefits and Off-System Sales" is an issue. The Company's calculation includes an estimate of the difference between the amount of Capacity release revenues and off-system sales actually achieved by Avista Energy, as well as an estimated amount of capacity

release/off-system sales that the Utility would achieve based on historical practices.

Q. DO YOU AGREE WITH THE COMPANY'S ESTIMATES?

A. No. First, the role of the gas procurement and capacity management function has changed. The Company itself states it would need more personnel than before the Mechanism went into place if the gas procurement and capacity management functions revert back to the Utility. (Exhibit No. _____ (RHG-1T), page 7). The Company also states the Utility would operate in a fashion consistent with the gas procurement strategy proposed in the Mechanism. (Exhibit No. _____ (RHG-1T), page 4).

However, the Company's calculation is based on how the Company would have operated before the Mechanism went into place. That is not an appropriate measure, because the market has changed, and the Utility would operate differently than before.

In addition, the Company's calculation uses Avista Energy's actual capacity release/off-system sales revenue for the period the Mechanism was in place. While this is an actual figure, it is not a representative one. This period included two months during the "Energy Crisis" in which Avista Energy was

able to capture approximately $10.4 million in net benefits. This anomaly should be excluded from the evaluation of what the Utility could achieve compared to Avista Energy. My presentation in Exhibit No. _____ (MPP-8) excludes this anomaly.

Q. DOES YOUR CONFIDENTIAL EXHIBIT NO. _____ (MPP-9C) PROVIDE A CALCULATION EQUAL TO ZERO FOR THIS COMPONENT, AS SHOWN IN YOUR EXHIBIT NO. _____ (MPP-8), LINE 6?

A. No. My Confidential Exhibit No. _____ (MPP-9C), line 21, indicates there is a net benefit to customers associated with this component. However, to be conservative, I have given Avista Energy the benefit of possibly providing greater than average benefits in the two-month period in question.

Q. WHAT IS THE NET BENEFIT TO THE UTILITY TO BRING BACK THE GAS PROCUREMENT FUNCTION?

A. The net benefit is $1,615,655, as shown on line 9 of my Exhibit No. _____ (MPP-8). (The negative number shown in the exhibit represents a benefit to customers if the Mechanism reverts back to the Utility. A positive number would be a net cost, such as shown in the table on page 7 of Mr. Gruber's direct testimony).

D. Comparison of the Proposed Mechanism to the Commission's Policy Statement on Gas Purchasing Incentive Mechanisms

Q. HAS THE COMMISSION ISSUED A POLICY STATEMENT REGARDING THE USE OF INCENTIVE MECHANISMS FOR GAS PROCUREMENT?

A. Yes. The Commission issued its Policy Statement May 16, 1997. A true and correct copy of that Commission Policy Statement is included in my Exhibit No. _____ (MPP-10).

Q. AS A THRESHHOLD MATTER, DO THE POLICIES CONTAINED IN THE COMMISSION'S POLICY STATEMENT REMAIN VALID SINCE THERE HAVE BEEN CHANGES IN THE MARKET SINCE THE POLICY STATEMENT WAS ISSUED?

A. For the most part, yes. The market has changed since the Commission's Policy Statement was first issued in May 1997. Gas costs are now substantially higher and more volatile. This requires utility managers be more flexible in order to rapidly respond to market conditions. However, for the most part, the principles contained in the Commission's Policy Statement remain fundamentally sound.

Q. PLEASE DESCRIBE YOUR ANALYSIS OF THE COMMISSION'S POLICY

STATEMENT IN LIGHT OF CURRENT CONDITIONS.

A. Principle No. 1 remains appropriate in that external benchmarks, where available, relevant, and reliable, are useful measures of performance when implemented as described in the Policy Statement.

Principle No. 2, requiring total gas costs to be included in the mechanism, also remains valid, although circumstances may exist where it is easier to track, measure, and protect against gaming on portions of the gas purchase function than on fully bundled gas purchases.

Principle No. 3, regarding simplicity, is very practical and sound. In this case, the use of Avista Energy, a subsidiary of Avista Corp., makes the Mechanism anything but simple to understand and apply.

Principle No. 4, regarding benchmarks based on the market, as opposed to historical gas costs, may need to be considered more broadly, to accommodate circumstances where indices are either unreliable or unavailable. In addition, there is a need to protect against purchasing strategies that fail to consider the best interests of ratepayers, versus simply "beating the market" for the benefit of shareholders. Otherwise, this principle remains sound.

Principle No. 5, preferring symmetrical revenue and risk sharing, remains fundamentally just.

Similarly, Principle No. 6, covering the concept of symmetrical risk sharing and implementation through dead bands, remains a useful concept.

Principle No. 7 treats incentive mechanisms as experiments, and requires explicit evaluation to determine whether the mechanism succeeded or not. This principle is more important today than it was in 1997, when the Policy Statement was adopted, given the rapid and negative changes in the natural gas industry over the past 3 years. Staff conducted a search for incentive mechanisms that have produced demonstrated improvements in gas purchase performance. We found no incentive mechanism that was supported by definitive evidence of performance improvements.

Principle No. 8 requires an incentive mechanism proposal to compare how the mechanism would have faired had it been in effect the prior three years. This remains a valid principle when initially placing an incentive mechanism into effect. The longer a mechanism is in place, however, the harder it is to compare with historical results.

Principle No. 9 requires that any index used in a mechanism be liquid. This should probably be expanded to require the Local Distribution Company demonstrate not only the liquidity, but also the transparency, availability, and reliability of each index proposed for use in an incentive mechanism.

Flexibility, as described in Principle No. 10, remains important. However, the emphasis should be on the flexibility of utility management to meet the needs of customers in changing natural gas markets. Less important is the need of a utility to tailor a mechanism to meet its nonregulated purposes.

Principle No. 11 states that in special circumstances, incentive mechanisms that do not have external benchmarks can be used, but the utility must provide an explanation why an alternative method is more appropriate. This principle is valid, assuming the special circumstances are accommodated only to the extent they are demonstrated to be necessary and useful to the utility and its customers.

Principle No. 12 discourages narrowly focused mechanisms, such as those that deal only with off-system sales. This principle may require new analysis. Certain complex, all-inclusive mechanisms may provide greater opportunities for gaming than less comprehensive mechanisms. Also, Staff believes the lack of proven track records for incentive mechanisms could be related to the difficulty of tracking results in comprehensive gas purchase incentive mechanisms.

Principle No. 13, requiring the tariffing of incentive mechanisms, remains sound. However, this principle should not apply, and does not appear intended to apply, to mere pricing mechanisms.

In operation, Principle 14 (tariffing procedures for PGAs, including

deferral procedures) continues to serve the purpose of streamlining the PGA review processes.

No compelling evidence exists to prefer pre-approval over Principle 15, which requires the Commission be able to review the prudence of management decision-making in rate proceedings or deferred gas cost filings. Lack of pre-approval encourages utilities to be flexible when responding to changing gas market conditions, and protect customers from risk while balancing the objectives of low cost fuel and rate stability.

In summary, overall the Commission's Policy Statement remains relevant and sound. Staff continues to monitor natural gas markets and may recommend changes at some future point. Those changes may include streamlining (such as combining Principle Nos. 5 & 6) and broadening of concepts (such as noted for Principle Nos. 4 & 9).

However, because natural gas markets are still in a period of rapid flux, and because the Policy Statement principles remain essentially sound even in these changed circumstances, Staff does not recommend a comprehensive review of the Policy Statement at this time.

The issues before the Commission in this docket can be resolved with a fresh look at existing policies.

Q. DOES THE COMPANY PROVIDE A THOROUGH ANALYSIS OF HOW ITS PROPOSED BENCHMARK MECHANISM CONFORMS TO THE COMMISSION'S POLICY STATEMENT?

A. No. The Company only recites a single principle from that Policy Statement, Principle No. 10, in which the Commission states in part: "The Commission should avoid a one-size-fits-all incentive mechanism. Each LDC should be allowed to file an incentive mechanism that conforms with these policies, and meets the company's specific needs." The Company states the Mechanism provides symmetrical sharing incentives and is fully auditable. The Company also asserts that the Benchmark Mechanism complies with the "spirit and intent" of the Commission's Policy Statement, but offers no further analysis. (Exhibit No. _____ (KON 1T), pages 11-13).

Q. DOES THE BENCHMARK MECHANISM CONFORM TO THE "SPIRIT AND INTENT" OF THE COMMISSION'S POLICY STATEMENT?

A. No. The Company's proposal is essentially a request for approval of a gas purchasing strategy and pricing mechanism, based on a non-arm's length transaction, without proving the services are rendered at the lower of cost or market. There is nothing in the Commission's Policy Statement that applies to a

request of this sort.

Q. DOES THE POLICY STATEMENT CONTAIN ANY REFERENCE TO THE USE OF A SUBSIDIARY TO PERFORM THE GAS PROCUREMENT FUNCTION?

A. No. Moreover, the use of a "non-arm's length" transaction greatly complicates the situation, contrary to Principle No. 3, which states in part: "Incentive Mechanisms should be simple to understand and apply, avoiding complex calculations which could lead to disputes or gaming."

Under the Benchmark Mechanism, Avista Corp. uses a wholly owned subsidiary to perform the gas supply and capacity management functions, adding great complexity to the process. As I described earlier, the Commission cannot apply the lower of cost or market standard because of the way Avista Energy operates. This makes the Mechanism inherently subject to dispute and controversy.

Q. DOES THE BENCHMARK MECHANISM CONTAIN SYMMETRICAL SHARING INCENTIVES CONSISTENT WITH THE COMMISSION'S POLICY STATEMENT?

A. No. Principle No, 5 of the Policy Statement states in part: "Revenue and risk

sharing should be symmetrized between the company and ratepayers…" Sharing under the Mechanism is symmetrical, in that it shares certain benefits 80 percent to customers/20 percent to Avista Energy.

However, Principle No. 5 also states: "incentive proposals should incorporate a risk of loss from poor performance as well as opportunities for rewards from good performance." The Benchmark Mechanism contains very little risk for Avista Energy. Other than a small amount of potential risk around the price on the volumes in Tier 3, Avista Energy can insulate itself from any risk.

If Avista Energy follows the JP synthetic injection/withdrawal schedule with storage, it loses nothing. Unless summer prices are higher than winter prices, Avista Energy would profit from the Mechanism. Historically, summer prices have been lower than winter prices.

Finally, the $3 million level of "guaranteed" capacity release/off-system revenues sales in the proposed Mechanism is so low that virtually no risk, and only reward, is provided to Avista Energy. I explain this later in my testimony.

Q. IS THE BENCHMARK MECHANISM CONSISTENT WITH THE POLICY STATEMENT REGARDING THE USE OF BENCHMARKS?

A. No. Principle No. 1 of the Policy Statement states in part: "The sharing

mechanism should be based on a comparison of actual costs to a benchmark." Thus, a benchmark is established to gauge performance, and if the Utility "beats" the benchmark, then a sharing of the benefits is appropriate.

Avista's Benchmark Mechanism fails this principle because it is not possible to measure Avista Energy's actual costs. But even if we had Avista Energy's actual costs, there is no benchmark standard with which to compare those actual costs. In effect, the proposed Mechanism is a pricing formula. It is not a benchmark mechanism in most respects.

Q. THE COMMISSION'S POLICY STATEMENT PRINCIPLE NO. 6 REFERS TO THE POSSIBLE USE OF "DEAD BANDS" WHICH, IF USED, SHOULD APPLY TO BOTH GAINS AND LOSSES. DOES THE BENCHMARK MECHANISM USE A DEAD BAND?

A. No.

Q. SHOULD A DEAD BAND BE USED?

A. No, because the risks to Avista Energy are minimal under the Mechanism, it would be difficult to establish a dead band that applies equally to gains and losses.

Q. IS AVISTA'S BENCHMARK MECHANISM CONSISTENT WITH PRINCIPLE NO. 14, WHICH STATES THAT GAS COST PROCEDURES BE TARIFFED?

A. Yes, but that creates other problems.

Q. PLEASE EXPLAIN.

A. Avista Corp.'s tariff prescribes in detail how the Company and Avista Energy will purchase gas, and otherwise operate under the Mechanism. Assuming these detailed tariff provisions are followed, this could amount to pre-approval of management's gas purchasing decisions.

In addition, the use of a tariff to prescribe a utility's' overall gas management practices and procedures creates less flexibility. Any change to the practices and procedures to respond to rapidly changing market conditions must await the tariff change process. The Company's proposal to extend the Mechanism to 2007, without further Commission review, makes the problem even worse.

IV. RECOMMENDATIONS

A. Staff's Primary Recommendations and Conclusions

Q. PLEASE STATE STAFF'S RECOMMENDATIONS AND CONCLUSIONS.

A. The Mechanism should be terminated and the gas procurement and capacity management functions should return to the Utility. Specifically, the Commission should not allow the proposed tariffs to go into effect. The Mechanism will therefore expire on January 29, 2004, under the terms of the existing tariff.

There are four main reasons for this recommendation. First, more benefits could be gained for customers by having the Utility provide the gas procurement and capacity management functions. This is shown on my Exhibit No. _____ (MPP-8), which I discussed in detail earlier.

Second, the lower of cost or market standard cannot be applied to the non-arm's length transactions involving Avista Energy as the purchasing agent for Avista Corp.

Third, the Benchmark Mechanism represents a fundamental change in the PGA policy of providing recovery of gas costs based on actual costs.

Finally, the Mechanism is not consistent with the Commission's Policy Statement.

B. Alternative Recommendations, Assuming Some Form of Mechanism is to Continue

Q. IF THE COMMISSION DECIDES TO ALLOW AVISTA ENERGY TO CONTINUE TO PROVIDE THE GAS PROCUREMENT AND CAPACITY

MANAGEMENT FUNCTIONS FOR THE UTILITY, DO YOU HAVE ANY ALTERNATIVE RECOMMENDATIONS?

A. Yes. I have three alternative recommendations. My Exhibit No. _____ (MPP-11) compares my Second and Third Recommendations with the Company's proposal. I will discuss this exhibit later in my testimony.

Q. PLEASE DESCRIBE YOUR FIRST ALTERNATIVE RECOMMENDATION.

A. My First Alternative Recommendation is that the Company be given the option of having the Mechanism expire pursuant to the tariff currently in effect, or, if the Company chooses to continue with the Mechanism, then it would be required to place the gas supply management functions currently being provided by Avista Energy out for competitive bid. The bidding process (including bidding rules, bid evaluation, and winning bid selection) must be controlled by an independent third party.

Q. WHAT IS THE PURPOSE OF PUTTING THE MECHANISM OUT FOR COMPETITIVE BID AND REQUIRING AN INDEPENDENT THIRD PARTY TO CONDUCT THE BIDDING PROCESS?

A. Because Avista Energy cannot identify its actual cost to serve the Utility, a

competitive bid process would at least determine the fair market value of the services provided to the Utility. Because of Avista Energy's relationship with Avista Corp., independent third party control over the process, including selecting the winning bidder, makes the process fair and equitable to all potential participants. Competitors would be less likely to participate if it appears they would have no chance of winning the rights to serve the Utility away from Avista Energy. It will also be essential that Avista Energy have no information about Avista Corp. that is not also available to other bidders.

Q. WHAT IS YOUR SECOND ALTERNATIVE RECOMMENDATION, ASSUMING THE COMMISSION CONCLUDES THE MECHANISM SHOULD CONTINUE IN SOME FORM?

A. My Second Alternative Recommendation is that significantly more benefits should be given to ratepayers in the form of guarantees. The guaranteed level of capacity release/off-system sales should be set at $7 million, not $3 million, as proposed by the Company. Under this alternative, the $900,000 management fee Avista Corp. pays to Avista Energy should be eliminated.

Q. WHY SHOULD THE CAPACITY RELEASE/OFF-SYSTEM REVENUE

GUARANTEE BE SET AT $7 MILLION AND NOT $3 MILLION?

A. Because the $3 million level is far below what should be readily achievable. This is demonstrated in My Exhibit No. _____ (MPP-12), entitled "Analysis of Capacity Release/Off-System Sales Revenues."

Lines 1-4 of this exhibit reflect the Company's calculation of what Avista Energy achieved in the way of capacity release/off-system sales revenue for the period September 1999 through September 2002. Avista Energy achieved an annual average of $8,248,577 in capacity release/off-system sales revenues over that period.

Lines 5-8 of the exhibit reflect Avista Corp.'s estimate of what the Utility would have achieved for capacity release/off-systems sales during the same time period. The Company's estimate shows the Utility would have achieved average annual revenues of $6,332,267 in capacity release/off-system sales revenues over that period.

These data show that a $7 million level of capacity release/off-systems revenues is reasonably achievable. The "guaranteed" level of such revenues in the Mechanism should be based on a level that would be achievable by the Utility. Only after that level has been achieved should any sharing begin. Avista Energy should only be rewarded for going beyond the Utility's capabilities, not

merely meeting them. The $3 million guaranteed level proposed by Avista Corp., with sharing after that level is achieved, would reward Avista Energy for below average performance.

Q. UNDER THIS SECOND ALTERNATIVE RECOMMENDATION, WHY DO YOU PROPOSE THAT THE $900,000 MANAGEMENT FEE BE ELIMINATED?

A. The fee is intended to compensate Avista Energy for the incremental costs of managing gas supply and capacity for the Utility. Under this Second Alternative Recommendation, the fee should be eliminated to give recognition to the many benefits Avista Energy receives that come from acquiring access to the Utility's load, pipeline capacity, and gas storage facility. Access to these valuable assets provides economies of scale and market presence to Avista Energy. Because customers are paying for capacity, they should be given credit for the valuable benefits conferred on Avista Energy, in the form of no management fee.

For example, Avista Energy accesses the Utility's pipeline capacity. Any pipeline capacity that is not needed to serve the Utility's loads can be used to Avista Energy's economic advantage, subject to any sharing percentages that may apply. This access to pipeline capacity is a significant advantage to Avista Energy, increasing its ability to manage and balance its total portfolio.

Avista Energy also has access to the Utility's JP storage facility, which gives Avista Energy greater flexibility to manage its total gas portfolio, even given a relatively rigid injection/withdrawal structure under the Mechanism. These are benefits that exist, but have not been quantified, and are difficult to quantify.

Q. UNDER YOUR SECOND ALTERNATIVE RECOMMENDATION, WHAT OTHER CHANGES SHOULD BE MADE IF THE MECHANISM IS MAINTAINED?

A. The basin weighting notification should be changed to every six months, effective October 1 and April 1, with two months notice. Under the current and proposed Mechanisms Avista Corp. will notify the Commission on or before January 1 of each year. The Commission has until February 1 to review the proposed assignment. The assignment then becomes effective starting November 1, nine months later.

Q. WHY SHOULD CHANGES TO THE BASIN WEIGHTINGS BE REQUIRED TWICE YEARLY?

A. This recommendation is related to the Company's proposal for a basin

optimization-sharing component, under which Avista Energy receives 20 percent of the benefits for optimizing the gas acquisitions at the lowest cost basin. Avista Energy does not control the prices at the basins, but can take advantage of the price differentials. Essentially, under the Company's proposal, Avista Energy would be rewarded for something over which it has no influence. If the Utility were managing the gas procurement function, then 100 percent of these benefits would go to customers. On the other hand, because Avista Energy has greater access to the markets in order to accomplish the daily transactions, it should receive some benefit. Accordingly, the basin weighting should only be adjusted twice per year instead of more often.

Q. WHY DO YOU PROPOSE ONLY TWO MONTHS NOTICE IN CHANGING THE BASIN WEIGHTINGS INSTEAD OF THE NINE MONTHS AS PROPOSED BY THE COMPANY?

A. The market is volatile and changes can happen quickly. Markets may be substantially different nine months later. The decision regarding basin weightings may no longer be appropriate.

Q. WOULD YOUR BASIN WEIGHTING PROPOSAL IMPACT HOW THE COMPANY WOULD OPERATE ITS HEDGES FOR FIXED PRICE GAS?

A. Yes. Currently, when the Company enters into a hedge, it does so proportionally at all three basins. I propose that the Company enter hedges into the basins based on the price at the date of hedging activity and supported by the advice of the Company's joint Strategic Oversight Group. This is a group consisting of Utility and Avista Energy personnel who meet periodically to determine appropriate hedges to use with respect to future gas purchases. This change will take advantage of market prices for the benefit of customers without harming the Company. To the extent these hedges force a deviation in the weighting percentages, the percentages should be adjusted.

Q. CAN YOU GIVE AN EXAMPLE OF HOW THAT WOULD WORK?

A. Yes. During 2002, the Rockies basin was substantial cheaper than both Sumas and AECO. Under my proposed change, the Company could maximize the amount of fixed price hedges based on capacity constraints at that basin. Even though the weighting at the time was 18 percent at the Rockies, the Company could have used 25 percent (the maximum level) and then adjusted the other basins for purposes of hedging, assuming the Strategic Oversight Group

examined the matter and concluded it was the appropriate thing to do for ratepayers.

Q. WHAT IS YOUR THIRD ALTERNATIVE RECOMMENDATION, SHOULD THE COMMISSION DECIDE THE MECHANISM SHOULD BE RETAINED IN SOME FORM?

A. My Third Alternative Recommendation is, in effect, to assign all Northwest Pipeline transportation capacity to Avista Energy, and then Avista Corp. would only pay for the pipeline transportation its customers actually use. Avista Energy would then be free to manage the pipeline capacity in any manner it chooses, keeping all gains or losses. This places the risk on Avista Energy to manage the capacity in the most efficient manner possible for Avista Energy.

Q. HOW WOULD CUSTOMERS BENEFIT FROM THIS ALTERNATIVE PROPOSAL?

A. Customers would get the benefit of being treated as 100 percent load factor customers, paying for only the transportation they actually used. This is the same effect as assuming Northwest Pipeline transportation is fully optimized.

Q. HOW WOULD AVISTA ENERGY BENEFIT FROM THIS ALTERNATIVE PROPOSAL?

A. Avista Energy would receive all capacity release/off-system sales revenues, and it would be free to manage the pipeline capacity in any manner it sees fit. Sometimes the value of transportation is worth more than the full tariff rate; while at other times it is not.

Q. WHAT WOULD THE COST TO CUSTOMERS BE AS COMPARED TO THE PROPOSED MECHANISM, IF YOUR THIRD ALTERNATIVE RECOMMENDATION WERE ACCEPTED?

A. Exhibit No. _____ (MPP-11), line 12, shows that Washington customers would pay approximately $3.38 million for transportation and the management fee, as compared to $5.22 million, as shown in the representation of the Company's proposal on line 20 of that exhibit.

Q. HOW WOULD AVISTA ENERGY HAVE FAIRED UNDER THIS THIRD ALTERNATIVE RECOMMENDATION, USING ITS HISTORICAL LEVEL OF CAPACITY RELEASE/OFF-SYSTEM SALES OVER THE TIME THE MECHANISM HAS BEEN IN EFFECT?

A. Avista Energy would have benefited annually an average of $738,324. This figure is derived by first subtracting the amount paid for by customers of $2,186,382 (Exhibit No. _____ (MPP-11), line 8) from the total Northwest Pipeline transportation demand charges paid to the pipeline in the amount of $9,696,635 shown on line 1 of the same exhibit. This amounts to $7,510,253 in Northwest Pipeline transportation demand charges for which Avista Energy would be responsible ($9,696,635 - $2,186,382 = $7,510,253). Avista Energy has been able to achieve actual average revenue of $8,248,577 (Exhibit No. _____ (MPP-12), line 4), for an average net benefit to Avista Energy of $738,324 ($8,248,577 - $7,510,253 = $738,324).

Q. WHAT WOULD YOU PROPOSE REGARDING THE MANAGEMENT FEE UNDER THIS THIRD ALTERNATIVE RECOMMENDATION?

A. I would recommend the $900,000 management fee be included in this alternative.

In my Second Alternative Recommendation, the rationale for eliminating the management fee was that under that version of the Mechanism, customers were paying for the capacity they did not use, and that unused capacity provided a benefit to Avista Energy that should offset the management fee.

Under my Third Alternative Recommendation, customers would pay only

for the capacity they use, and not for the capacity that can be used by Avista Energy for other purposes. In other words, the offsetting factors that existed in the Second Alternative Recommendation, justifying elimination of the management fee, are not present in the Third Alternative Recommendation.

The fee is included in my Third Alternative Recommendation, as shown on my Exhibit No. _____ (MPP-11), line 11. My First Alternative Recommendation would let the market determine whether any amount of fee at all is justified, so that recommendation is preferable.

Q. DO YOUR RECOMMENDATIONS RELATING TO THE BASIN WEIGHTING ALSO APPLY TO THIS THIRD ALTERNATIVE RECOMMENDATION?

A. Yes.

Q. UNDER ANY OF YOUR ALTERNATIVE RECOMMENDATIONS, WHAT IS THE APPROPRIATE TERMINATION DATE FOR ANY ALTERNATIVE MECHANISM?

A. A termination date of March 31, 2005, should be used. This would provide a meaningful time for the Mechanism to operate under the alternative parameters, and would permit a reasonable basis for evaluation. The expiration date would

also coincide with the expiration date of the mechanisms currently in place in Idaho and Oregon.

Q. WHAT REPORTING REQUIREMENTS SHOULD BE IMPOSED?

A. The design of reporting requirements is a difficult problem, given the audit difficulties and lack of actual cost data I previously described. If the Commission approves a continuation of the Mechanism, I recommend that the Commission set as a compliance item the design of appropriate reports for Commission acceptance.

Q. DO YOU HAVE ANY FURTHER DIRECT TESTIMONY AT THIS TIME?

A. No.