BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	DOCKET NO. UE-011595 MEMORANDUM OF COMMISSION STAFF EXPLAINING SETTLEMENT STIPULATION

This memorandum is provided to assist the Commission in understanding the proposed Settlement Stipulation ("Stipulation") filed by the parties on May 31, 2002, and to explain why Staff believes the settlement is in the public interest. The Stipulation is subject to Commission approval. (Stipulation pages 2-3). A hearing for presentation of the proposed settlement is set for Wednesday, June 12, 2002. A hearing for public comment is set for June 10, 2002.

I. OVERVIEW

Staff recommends the Commission approve the Stipulation because it provides an appropriate balance between several distinct considerations presented in the instant docket:

1. The rating on the Company's debt has been downgraded to below investment grade, due primarily to extraordinary power costs Avista incurred to serve customers.

2. The Company is experiencing significant pressure from the investment community to implement an energy cost recovery mechanism for its Washington electric operations.

3. The Company has been in a long-term deficit resource position, requiring it to obtain new resources, which has caused upward pressure on rates.

4. Customers have experienced a significant increase in rates due to the combined effects of the Company's recovery of extraordinary power costs and the costs of obtaining additional long-term firm resources.

Staff believes the Stipulation is in the public interest for the following reasons. The Stipulation:

1. Achieves a degree of rate certainty for Avista's customers, because it avoids immediate increases in customers' rates by maintaining the rate levels previously authorized on March 4, 2002.

2. Continues or enhances the rate mitigation measures previously approved by the Commission in a prior stipulation.

3. Resolves the uncertainty with respect to the Company's exposure to extraordinary power costs during 2000 and 2001.

4. Implements an energy cost recovery mechanism, with an appropriate sharing of risk between shareholders and ratepayers, consistent with traditional rate base, rate of return regulation.

5. Provides an orderly way for the Company to recognize in its financial statements the change from deferred power cost accounting to the proposed energy cost recovery mechanism ("ERM").

6. Provides the Company the necessary revenues to recover the costs of new long-term, least-cost, appropriate risk resources it has acquired to serve core customers.
7. Is based on a revenue requirement that reflects consideration of outstanding issues related to power supply and power cost modeling the Commission directed the Company to address in Docket No. UE-991606, the Company's last general rate case.
8. Provides an opportunity for the parties to review issues related to power supply recovery under the ERM in 2006.

The Stipulation will provide the Company an opportunity to earn a fair return on the facilities devoted to serving its electric customers. The Stipulation provides Avista with a reasonable opportunity to turn its financial situation around and to restore the investment community's faith in the Company. The ultimate goal is for Avista to regain an investment grade rating on its securities, which will translate into customer benefit.

For these principal reasons, Commission Staff recommends that the Commission enter an order approving the Stipulation as filed.

II. BACKGROUND

There have been several dockets, both pending and resolved, that have some relationship to the instant docket, Docket No. UE-011595. These dockets are described below in order to provide a context for the Commission's decision.

Docket No. UE-011595. This is the docket in which this Stipulation is filed. This is the general rate case filed by Avista. This docket raises issues of revenue requirements, Power Cost Adjustment (PCA), and other issues. In this docket, Avista filed tariffs reflecting a general rate increase of 22.5%, and seeking to implement a PCA mechanism. As a result of the earlier

settlement stipulation approved by the Commission in this docket and Docket No. UE-011514, the Commission approved a rate increase of 6.2%, effective March 6, 2002.

Docket No. UE-991606. This was the last general rate case for Avista. In its Third Supplemental Order in Docket No. UE-991606 (September 29, 2000), the Commission ordered that in the next general rate case, Avista was required to address the following specific issues: Potlatch contract costs, the implementation of a more sophisticated power dispatch model, the results of the Company's request for proposals concerning power resources, the replacement of Centralia generation, and the rate making treatment of market transactions. Staff reviewed each of these issues in detail. Staff's analysis of these issues is summarized in Section IV of this Memorandum.

Docket No. UE-000972. In this docket, Avista petitioned for an accounting order permitting it to defer certain power costs for potential later recovery. The Commission granted the petition, but did not specify the recovery method or timing of recovery. The initial method of calculating the deferred power costs compared the output of Avista-owned plants to Avista's normalized native load, and priced the difference at market prices. In December 2000, the Commission approved an Avista petition seeking to change the method of calculation to a method that compared Avista's power purchases, fuel, and secondary sales to the levels upon which rates were set in the last general rate case. The accounting order expired December 31, 2001, but was followed by an accounting order in Docket No. UE-011597. See below.

Docket No. UE-010395. In this docket, Avista requested the Commission to approve recovery of deferred power costs, without increasing rates. A settlement stipulation in that docket was approved by the Commission on May 23, 2001. The assumptions underlying that stipulation did not bear out, and Avista then requested a surcharge of over 30%, to begin the

amortization of the deferred power costs. The Commission approved a 25% surcharge effective October 1, 2001. The surcharge revenues were subject to refund, and the prudence of the deferred power costs was left to a later docket. The 25% surcharge produces approximately $59,242,000 per year in revenues. After revenue related taxes and expenses, it produces slightly less revenue for amortization of deferred power costs.

Docket No. UE-011597. In this docket, Avista requested an accounting order approving power cost deferral accounting. The Commission approved the Company's request, effective January 1, 2002, until the effective date of the Commission's Order in the general rate case.

Docket No. UE-011514. In this docket, Avista requested that the power costs deferred through September 2001 be deemed prudent and recoverable in rates. This docket was processed in connection with the instant docket. The Commission approved a settlement stipulation that resolved deferred power cost recoverability issues for power costs deferred through December 31, 2001.

III. KEY ELEMENTS OF THE STIPULATION

A. Resolution of Revenue Requirements Issues (Stipulation pages 3-4, ¶ II.1)

Since October 1, 2001, the Commission has approved rate increases for Avista in the amount of 31.2%, or about $73,914,000 annually. This was accomplished by a 25% surcharge effective October 1, 2001, and a 6.2% increase effective March 6, 2002. These revenues are currently allocated $14,672,000 to general revenues, and $59,242,000 to offset deferred power costs that have been deemed recoverable.

The Stipulation proposes to make no change in the overall level of rates customers pay. The Stipulation does change the allocation of the Company's revenues between recovery of

prior period power costs and general revenues. Under the Stipulation, $45,722,000 (19.3% approximately) would be allocated to general revenues and $28,192,000 (11.9% approximately) would be allocated to deferred power cost recovery. This reflects the resolution of the revenue requirements issues in the instant docket. In Section IV.A. of this Memorandum, Staff explains why it believes the $45,722,000 revenue amount is a reasonable resolution of the revenue requirements issues.

As noted, the Stipulation results in no change in overall revenues, and thus no change in current billing rates (other than a minor change in Schedule 25 as described on page 4 of the Stipulation). Customers can expect no new rate increase as an immediate result of this Stipulation.

B. Resolution of Recovery of Power Costs Deferred from January 1, 2002 to June 30, 2002 (Stipulation page 4, ¶ II.2)

The parties agree that Avista's power costs deferred between January 1, 2002, and June 30, 2002, are recoverable based on a sharing of such costs 90% to ratepayers and 10% absorbed by Avista. This is the same sharing in the stipulation approved by the Commission in Docket No. UE-011514.

The implementation of the Energy Recovery Mechanism, discussed next, follows the June 30, 2002, termination date of the temporary deferral mechanism. Staff considers this resolution to be reasonable in light of the overall structure of the Stipulation, which includes the ERM. Staff's analysis of the deferral issues in the post December 31, 2001, period is summarized in Section IV.B.1. of this Memorandum.

The cumulative deferred power cost from January through April 2002, is a negative $640,898, that is, a net reduction to the total balance. May and June deferral balances for 2002 are, of course, yet to be determined. The current method of calculating deferred power costs

through the end of June 2002, remains in place and the result will be added to the current total Energy Cost Deferral Balance.

The Stipulation provides that the current surcharge in effect under Schedule 93 shall be reduced to recover $28,192,000 per year (under normal weather and hydro conditions). (Stipulation page 3, ¶ II.1). Schedule 93 began as the 25% surcharge effective October 1, 2001. In its Fourth Supplemental Order in Docket No. UE-011514, the Commission approved recovery of $196,023,342 in power costs deferred through year end 2001. This balance has been reduced by the application of a deferred credit from the PGE Monetization and by receipts from the surcharge. As of April 2002, the approved remaining balance from December 2001 is about $115,248,000.

The proposed reduction to the surcharge under the terms of the Stipulation implies that, in the expected case, the $115 million in deferred power costs will be recovered by around the end of 2006.

C. Resolution of PCA Issues: The Energy Recovery Mechanism ("ERM")(Stipulation pages 4-8, ¶ II.3)

An Energy Recovery Mechanism ("ERM") is proposed to be implemented beginning July 1, 2002. The details are set forth in ¶ II.3 of the Stipulation.

In brief, the ERM tracks Avista's power expenses and revenues from four FERC accounts (Accounts 447, 501, 547 and 555), which comprise the Company's major power supply cost accounts, and compares these amounts to "base" levels for these accounts. The "base" levels are shown in Attachment 1 to the Stipulation. The base levels result from the pro forma power supply analysis demonstrated in the general rate case. As explained in Part IV, below, Staff thoroughly evaluated the company's presentation of pro forma power supply cost. On that basis, Staff recommends the "base" levels be accepted.

Other additions to the ERM include the actual lease cost of the Kettle Falls Bi-fuel generating units for July through October 2002, and actual fuel expenses not included in Account 547. The fuel expense not included in Account 547 is the natural gas purchased for combustion turbines, but not needed. The gas is sold at market prices and the profit or loss is included in the ERM.

The ERM is also adjusted for changes in retail load. The retail revenue adjustment is based on the variation of actual kwh sales from the normalized retail load. This difference is multiplied by the embedded cost of power (3.208 cents per kilowatt-hour). The retail revenue adjustment is added or subtracted to the ERM.

As explained on pages 6-7 of Stipulation, ¶ II.3 a "Company Band" of $9 million annually is created under the ERM. This means that if the power supply costs tracked by the ERM that exceed the "base" costs for those accounts by less than $9 million in one year, and no power costs are added to power cost deferral balances and no rate change occurs.

If the power supply costs tracked by the ERM exceed the "base" costs by more than $9 million in one year, no rate change occurs immediately, but 90% of the excess is added to power cost deferral balances. Avista expenses the 10% excess portion.

On the other side of the Band, if the power supply costs tracked by the ERM are less than the "base" costs by more than $9 million in one year, no rate change occurs immediately, either. But 90% of the excess is used to offset power cost deferral balances. Avista realizes the 10% excess portion of the benefit.

Before April of each year, Avista reports its prior calendar year experience under the ERM. That report is subject to a full review and audit by the parties. (Stipulation pages 6-7, ¶

II.4.b). An overall review of the ERM will be initiated in December 2006. (Stipulation page 7, ¶ II.4.c).

The Stipulation provides that the revised surcharge rate in Schedule 93 will remain in place until the Energy Cost Deferral Balance reaches zero. (Stipulation page 4, ¶ II.1). The Energy Cost Deferral Balance is defined as the sum of the approved deferred power costs as of December 31, 2001, plus or minus the deferrals from January through June 2002, plus or minus any balances determined by operation of the ERM. (Stipulation page 4, ¶ II.2). The revenues raised by the surcharge proposed in the Stipulation ($28,192,000) will provide about $27 million to amortize the accumulated deferred power costs, after revenue related taxes and expenses. It is expected that rates will decrease about 10 per cent once the Schedule 93 surcharge fully amortizes the deferral balance.

Rate changes after the termination of the surcharge will occur pursuant to the terms of the ERM. (Stipulation page 7, ¶ II.4.f). The allowed deferred power costs (derived from amounts above or below the band and after the shared 10%) must accumulate to at least ten percent of general revenues before the Company can file for recovery in rates. When that occurs, the Company will file for a tariff change with an effective date 90 days later. The 90 days allows time for a review and approval process. This rate change is intended to recover the ERM deferred power costs within one year. Only one such ten percent increment will be imposed at any one time.

The Energy Recovery Mechanism required compromises from all parties. Staff's interests included imposing sufficient risk on the Company to justify the existing return on equity, placing incentives on the Company to maintain good power purchasing practices, and

giving the Company the flexibility to manage its power portfolio as it sees fit. Staff believes the proposed ERM accomplishes these goals.

D. Customer Mitigation Measures (Stipulation pages 8-10, ¶ II.5)

The Stipulation proposes to continue or enhance certain mitigation measures contained in the Stipulation approved by the Commission in its Fourth Supplemental Order in Docket Nos. UE-011514 and UE-011595. Most of these measures are proposed to continue until June 30, 2003, unless the Commission grants a petition to extend or revise a specific measure. The exceptions are: a) the payment Avista agrees to make to Project Share continues until deferral balances become zero, and 2) various customer fees are established with no termination date. (Stipulation page 10, ¶ II.5.e and f).

E. Tariff Rider Changes (Stipulation page 10, ¶ II.6)

The Stipulation recognizes the existing Demand Side Management (DSM) tariff rider needs to properly match prospective revenues and prospective DSM program costs. The Company commits to meet with interested parties and propose modifications to the Rider to reflect those considerations. The result will be subject to Commission approval.

IV. STAFF'S ANALYSIS SUPPORTING THE STIPULATION

In the course of preparing its analysis in the instant docket, Commission Staff conducted an in-depth analysis of the Company's revenue requirements, including power supply issues. It is on the basis of this analysis that Staff is able to recommend that the Commission approve the Stipulation.

In its Third Supplemental Order in the last general rate case, Docket No. UE-991606, the Commission ordered that certain specific power supply issues be addressed. Accordingly, Staff

provides a description of the analysis it performed, which leads Staff to recommend approval of the Stipulation.

No party needs to agree or disagree with Staff's analysis. It is offered to provide the Commission with Staff's perspective on why the Stipulation is consistent with the public interest.

A. Revenue Requirements Overall

In the instant docket, Avista filed tariffs that would generate an increase in general electric service revenues of $53,247,000, an increase of about 22.5% over general rates established in UE-991606. This request was reduced to $45,722,000 (a 19.3% increase) per the agreements reached in the earlier settlement stipulation approved by the Commission in its Fourth Supplemental Order in this docket, and Docket No. UE-011514. One effect of that earlier stipulation was to grant an increase of $14,672,000 in general revenues, or 6.2%.

Staff investigated the Company's proposed general retail revenue increase of $45,722,000, which leads to total pro forma retail revenues of $282,490,000 (Washington). Every Company-proposed adjustment was analyzed in detail. In addition, Staff conducted an independent review of the Company's books of account. Additional adjustments were found. Some increased revenue requirements, and some decreased revenue requirements. The level of executive wages has been an issue of general interest in the past Staff's review of Avista's records and adjustments found no expenses related to the former CEO, Mr. Thomas "Tom" Matthews. Moreover, the overall level of executive compensation was in line with Staff's analysis and recommendations in the last general rate case.

Based on Staff's review and audit, Staff is satisfied that the Company's electric revenue requirements portrayal is consistent with past Commission orders. Staff is therefore able to

recommend the Commission accept $282,490,000 as Avista's total pro forma total normalized retail revenues for the Washington jurisdiction for the test year ended December 31, 2000.

B. Power Supply Issues

Staff evaluated power supply issues in two contexts: 1) as they relate to ongoing deferrals, and 2) as they relate to general rate case issues. Staff reviewed the prudence and recoverability of power supply expenses contained in Avista's post-December 31, 2001 deferrals (authorized by the Commission in Docket No. UE-011597). Staff then reviewed the prudence of new power supply resources, and the appropriate level of pro forma power supply expenses to be used in determining Avista's revenue requirement.

As noted earlier, in its Third Supplemental Order in the last general rate case, Docket No. UE-991606, the Commission set forth several issues that needed to be addressed in the next general rate case, i.e. the instant docket. Those issues were Potlatch contract costs, the implementation of a more sophisticated power dispatch model, including use of appropriate water record and dispatch flexibility, the results of the Company's request for proposals concerning power resources, the replacement of Centralia generation, and the rate making treatment of market transactions. Staff reviewed each of these issues in detail.

1. Deferrals

a. General Issues

The settlement stipulation approved in the Commission's Fourth Supplemental Order in Dockets Nos. UE-011514 and UE-011595 resolved the issues of prudence and recoverability with respect to power costs deferred over the period October 1, 2001 through December 31, 2001. It also provided that certain costs associated with newly acquired generating resources be

excluded from power costs deferred after December 31, 2001. Those costs would be evaluated on a prospective basis as part of the general rate case.

From a Staff perspective, the remaining relevant deferral issues include: the actual mechanics of the deferral calculation, the prudence of costs tracked in the deferral, and the disposition of the resulting deferral balances at the end of the deferral period.

The Stipulation resolves all of these deferral issues. Staff is recommending the present power cost deferral mechanism continue until the Energy Recovery Mechanism ("ERM") begins on July 1, 2002. This includes the 90% customer/10% Company sharing percentages, and an adjustment related to unused natural gas that is sold at a loss or gain. Presently, favorable hydro-generation conditions are providing an offset to these costs through the ongoing deferral mechanism.

As described in Section IV.B.2.a. below, the Stipulation also resolves issues associated with those new resource costs (capital costs, interest, and non-fuel operating and maintenance costs) which were specifically excluded from the deferral calculation in the previous settlement stipulation. These costs were to be addressed in the general rate case.

b. Gas Hedging Contracts

As part of its investigation of the ongoing deferral amounts, Staff analyzed certain contracts entered into by Avista in March, April and May, 2001. In March 2001, Avista entered into four contracts by which it purchased a total of 48,000 decatherms of gas at a floating, market based rate over the periods November 1, 2001, to October 31, 2004, and June 1, 2002, to October 31, 2003. These purchases constituted about 50% of Avista's total gas load for electric operations, so the amounts are significant.

In April and May 2001, Avista entered into "hedging" contracts, by which Avista effectively "fixed" the price of 40,000 decatherms of natural gas in the range of $5.35 to $6.75 for the same periods.

The Company included only the market-based price of gas in its test year results of operations. The Company included the cost of these contracts (excess of the hedge price over market) in its calculation of deferred costs under its proposed PCA. These contracts heavily influence the deferrals. These contracts also continue to affect Avista's costs into 2004.

Staff was concerned about the prudence of these hedging contracts. If this case went to hearing, Staff was prepared to challenge the Company's decision to enter into these contracts . Staff expects the Company would vigorously oppose Staff's position regarding the appropriate rate treatment of these contracts.

The Stipulation does not resolve this prudence issue directly. But from Staff's perspective, it does address the issue in a meaningful way. The "sharing bands" contained in the proposed ERM provide an opportunity for the Company to manage its resources and take advantage of favorable hydro conditions in order to offset gas costs that are presently out of market, without a substantial rate impact.

Finally, the Settlement Stipulation provides that the temporary deferral period will run from January 1, 2002 through June 30, 2002. Starting on July 1, 2002, the Energy Recovery Mechanism (ERM) will be implemented. The Settlement Stipulation provides that any deferral balances, plus or minus, will be consolidated with the remaining energy cost deferral balance authorized for recovery pursuant to the previously mentioned Fourth Supplemental Order.

Staff has evaluated the monthly deferral reports Avista has filed to date. Staff concludes the Commission should permit recovery of these costs through the deferral mechanism, in the context of the overall structure of the Stipulation.

c. Potential Effects of FERC Actions

Recent events have suggested that the high prices paid by Avista during 2000 and 2001 may have been the result of unlawful market manipulation. There may be proceedings brought or reopened that will address these issues. To the extent Avista receives compensation related to transactions that resulted in deferral of power costs for which the Commission has granted recovery, that compensation will be used to reduce deferral balances.

2. General Rate Case Power Supply Issues

a. Prudence of Avista's New Power Supply Resources

As part of the revenue requirements analysis, Staff reviewed the Company's pro forma power supply adjustments, including costs associated with newly acquired resources.

Since the Company's last general rate case, some large generating resources were added to the Company's resource portfolio: the Company's fifty-percent ownership in the Coyote Springs II generation project, the Boulder Park project, and the Kettle falls CT generation project. These resources were acquired either through a Request for Proposal process, or through Company actions taken during the period of unprecedented wholesale energy price volatility. Subsequent evaluations determined that these projects remained viable, as wholesale markets recovered and returned to more historical levels. While these projects have resulted in upward rate pressure as they are added to the Company's results of operations, Staff believes they will provide benefits in the form of firm energy supply and a reduction in exposure to the more volatile wholesale markets. Staff's analysis found that these projects were prudently acquired

and that the Company should be allowed to recover associated costs, including capital costs, interest, depreciation, and non-fuel O&M costs on a prospective basis.

Staff also evaluated several other Company actions regarding power supply resources. Staff reviewed the Company's decision to sell a one-half interest in the Coyote Spring II generating project. Due to near-term financial conditions, the Company had evaluated several options to decrease its participation in the project. The Company determined the half interest sale provided the most value under the circumstances, as well as increasing the Company's flexibility in regard to future acquisitions. Staff accepts the Company's conclusions.

The Company also addressed some immediate needs during the volatile wholesale market period by agreeing to install new pollution control equipment at its Northeast Combustion Turbine facility in order to reduce emissions and increase potential operation hours six-fold. This commitment allowed the company to operate the facility in 2001 under the Governor's Energy Alert. This relatively low cost option affords additional flexibility to the Company in meeting future energy needs under a variety of water and market conditions. The long-term benefit of this additional operating flexibility has been captured by the Company's new dispatch model when determining normalized power supply expense levels.

b. Centralia Steam Plant

As noted above, the Commission required the Company to address the issue of replacing generation resulting from the Company's sale of its share of the Centralia Steam Plant. The original resource replacing Centralia consisted of a 200 MW purchase from TransAlta, the new owner of Centralia. The cost of that transaction was approved in the last general rate case.

Avista's contract with TransAlta expires in June 2003. The Company's long-term replacement of energy from Centralia was included as part of its resource assessment beginning

in the Spring of 2000. The result of that assessment and subsequent RFP was Avista's acquisition of the Coyote Springs II project. However, as a result of Avista's sale of one-half interest in the project, the Company plans to seek additional resources to fill its resource needs in 2004. Based on the Company's immediate resource portfolio and the anticipated operation of the Coyote Springs II project, Staff believes that this path is acceptable. Staff will also participate in future resource planning processes as well as any subsequent RFP submittals and evaluations.

c. Other Pro-Forma Power Supply Issues, Including the New Dispatch Model and Potlatch Issues

Staff reviewed all of the Company's pro forma power supply adjustments, including the proposal to use a sixty year water record for purposes of determining the appropriate normalized power supply expense level. Staff's review was carried out in several parts. First, Staff evaluated the Company's new dispatch model. Second, Staff reviewed each of the Company's assumptions and inputs to the dispatch model, including market and fuel prices. Third, Staff evaluated the Company's water record proposal. Finally, the results of the dispatch model were reviewed and incorporated with other costs to determine the total normalized power supply expense level.

In its Third Supplemental order in Avista's last general rate case, Docket No. UE-991606, the Commission ordered Avista to implement a more sophisticated power supply dispatch model for ratemaking purposes. In the instant docket, the Company incorporated a new dispatch model that allows system resources to be dispatched on an hourly basis, which more accurately reflects actual system operations. The new model has significant advantages over the previous model in that it has: 1) the ability to "peak shave" or shift hydro-production to the most beneficial period, 2) the ability to model various reserve requirements, 3) the ability to

incorporate hourly pricing differences, and 4) the ability to incorporate various thermal plant constraints.

The Company provided a software license and opportunities for training to enable Staff to have access to the model. The Company continues to evaluate various models that will meet its needs in the future.

Staff reviewed the basic input data used in the new dispatch model. This data includes such requirements as hourly loads, energy prices (both electricity and gas), thermal plant operating characteristics such as heat-rate curves and availabilities, hydro-project operating characteristics, long-term wholesale purchase and sales contracts, and reserve requirements. The Company used forward price curves for purposes of estimating short-term energy prices. Monthly forward prices where shaped into hourly prices using a hourly price forecast developed in 2000 by a consultant for the Company. Several hourly pricing scenarios were developed and assigned to various water conditions in order to capture the relationship between hydro-conditions and wholesale energy prices. For purposes of pricing gas that is used as fuel, the Company uses a market price based forecast. This model does not incorporate the out-of-market fixed price contracts entered into by the Company.

For purposes of inputting capacity and energy availabilities, the Company is proposing to use the full sixty-years of data available from the 2000-2001 Northwest Power Planning Headwater Benefits Study. The study simulates the operation of regional reservoirs over 60 water years and assigns monthly capacity and energy amounts during each month of a water year given current rules for each reservoir's operations. The Company's dispatch model is then run for each of the 60 years to determine the level of short-term market purchases, short-term market sales, and the various fuel amounts and costs to operate Company-owned thermal resources.

Normalized amounts for these items are determined by averaging the quantities on a monthly basis over the study period. Those amounts are then included with the other fixed power supply expenses and revenue credits to determine the overall pro forma power supply expense level.

In its direct case, the Company provided significant testimony supporting its proposal to use the full sixty years of water data in this proceeding rather than the 40 year rolling average methodology previously adopted by the Commission. Staff was prepared to offer a simpler, less statistically-oriented approach for what water years to use in the dispatch model. However, for purposes of this Settlement Stipulation and in the context of implementing the ERM, Staff accepts the Company's 60 year water record methodology proposal and resulting model results, without stipulating to the appropriateness of such a water records methodology in the future.

Staff also reviewed the costs and revenues associated with the wholesale purchase and sales transactions of the Company, including those related to Potlatch Corporation. For many years, the Company has had both power purchase and power sales contracts with Potlatch, an Idaho retail customer. There has been in place an agreement to allocate certain Potlatch revenues to the Washington jurisdiction in order to minimize the detrimental effects of the purchase and sales contracts using normal allocation procedures. Those contracts have now expired and the exact characteristics of Potlatch load are unknown at this time.

Given these uncertainties, Avista is proposing to maintain the current revenue/cost relationship by making several adjustments, one to remove some of the Potlatch load estimated to be met through self-generation, another to directly assign the remaining estimated Potlatch load to Idaho and, finally one to credit the Washington jurisdiction an amount based on serving the load at average energy prices. Under this methodology, the risks associated with incremental changes in Potlatch load will neither be assigned, nor allocated, to Washington.

For purposes of the Stipulation, Staff can accept the Company's proposed methodology for Potlatch. However, in future rate cases, Staff may propose alternative methodologies that reflect the actual characteristics of future Potlatch loads.

Staff reviewed and found acceptable the Company's pro forma estimates for other power supply expenses and revenues including those related to transmission and wheeling. The same is true for the various smaller adjustments made by the Company to remove various one-time costs or revenues that should not be reflected in pro-forma power supply expense.

d. Conclusions on General Rate Case Power Supply Issues

Evaluation of the power supply costs itemized above, combined with a careful review of the inputs and outputs from the new dispatch model, Staff is led to recommend the Commission approve the level of pro forma power supply expense as filed by the Company. This level serves as the "base" level of power costs that are included in the ERM, as shown on Attachment 1 to the Stipulation.

V. CONCLUSIONS

As the Commission characterized its prior action in its Fourth Supplemental Order in this docket: "[This] represents another positive step in the direction of restoring the financial integrity of one of Washington State's major electric utilities, and simultaneously helps to ensure that Avista's customers continue to receive reliable service at reasonable rates. (Order at page 3).

The Stipulation, if accepted, would be another major positive step in the same direction. The Stipulation addresses the major regulatory issues facing Avista since its last general rate case. These include normalized power supply costs, treatment of new resource acquisitions, and certainty regarding the recovery of Avista's power supply purchases during the West Coast power crisis. The Stipulation is a plan to overcome financial uncertainty, and includes a power

cost recovery mechanism, and a plan to stabilize the rates customers pay for reliable electric service.

The Stipulation reflects a careful balance of competing, diverse factors and interests. In Staff's view, the balance struck in the Stipulation achieves the overall goal of protecting the public interest. Therefore, the Stipulation should be accepted by the Commission.

DATED this 3rd day of June, 2002.

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