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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF AVISTA UTILITIES' APPLICATION FOR APPROVAL OF MODIFICATIONS TO ITS NATURAL GAS BENCHMARK MECHANISM	)	**CASE NO. AVU-G-01-3**
	)	**COMMENTS OF THE COMMISSION STAFF**

COMES NOW the Staff of the Idaho Public Utilities Commission, by and through its Attorney of record, Lisa Nordstrom, Deputy Attorney General, and in response to Order No. 28916, the Notice of Application and Notice of Modified Procedure issued on December 13, 2001, submits the following comments.

On November 8, 2001, Avista Utilities (Avista; Company; Utility) petitioned for Commission approval to continue its current Natural Gas Benchmark Incentive Mechanism (Benchmark or Benchmark Mechanism) with several proposed modifications. Avista is **NOT** proposing a change in rates or annual revenue in this filing.

THE CURRENT BENCHMARK MECHANISM

The Benchmark Mechanism was originally approved by Order No. 27908 in February 1999 and expires on March 31, 2002. It works in conjunction with the existing Purchased Gas Adjustment (PGA) Mechanism. Deferrals for the PGA are calculated each month based on the

costs and revenues from the Benchmark Components, as well as other costs normally included in the PGA. According to Avista's petition, the Benchmark Mechanism provides: 1) a relatively simple and objective determination of the gas costs to be charged to customers; 2) additional gas cost savings to customers; and 3) a significant shift of gas procurement and management risk to Avista Energy.

The current Benchmark Mechanism is comprised of three major components. The Commodity Component consists of a calculated Weighted Average Index Price for natural gas based on published index prices for three supply basins, plus an Index Adder of $0.05 per dekatherm. According to Avista's Petition, the JP Storage Component provides additional savings to customers from the operation of the JP Storage Project. Finally, the Capacity Release/Off-System Sales Component provides a guaranteed level of savings to customers from the release of pipeline capacity and off-system sales.

STAFF REVIEW OF CURRENT BENCHMARK MECHANISM

Before the Benchmark, the Company purchased the majority of its gas using long-term supply contracts with prices based on the first-of-month indices. Any shortage of gas was purchased on the open market, and any excess gas was disposed of on the open market. Customers paid exactly the same amount for the gas as the Company did. Although this method assured a reliable gas supply, all the risk associated with price swings was borne by the customers.

In 1998, the Company proposed a Benchmark Mechanism that allowed it to purchase gas from its affiliate, Avista Energy (Energy). That Benchmark Mechanism, which is effective through March 2002, prices all the natural gas purchased by Avista Energy for the Utility at a Benchmark price based on weighted-average, first-of-the-month indices. This pricing method is very similar to the long-term contracts method except it protects customers from daily price swings by shifting the daily volatility to Avista Energy. In a stable wholesale market consumer prices were relatively constant, easily calculated and posed little risk to the customers and the Company. During the recent volatile market, the Company took steps to increase price stability for customers and was authorized in February 2001 to defer fixed-price contracts and/or financial instrument expenses relating to the purchase of gas.[1] These fixed-price contracts and instruments

[1] See Order No. 28639 for Case No. AVU-G-00-07 for more details.

were meant to protect customers from volatile spot market prices. This Application also seeks to reduce the overall risk of price volatility.

Since the current Benchmark Mechanism was established in 1998,[2] Staff and the Company have been monitoring its effect on customers' gas prices. During the last three years, unprecedented price fluctuations have made it difficult to accurately compare the Benchmark Mechanism to other purchasing alternatives. However Staff does not believe the current Benchmark Mechanism has harmed customers, nor has it unduly enriched Avista Energy. Although the Company states that customers have benefited by approximately $7,000,000 through off-system sales, capacity releases and storage benefit, Staff believes that customers probably would have received most of these benefits had the Company (rather than Avista Energy) been responsible for gas acquisition. The only verifiable savings over the pre-Benchmark period have resulted from the annual $35,300 credit for overhead reductions. Although the verifiable savings are limited, Staff believes there have been other savings to Avista customers as compared to what costs could have been under alternative gas purchase methodologies. For example, Avista customers pay no additional demand charges for gas procurement, per-therm charges for off-system capacity releases or storage fees. In addition, Avista's Benchmark Mechanism shifts many of the gas procurement expenses associated with credit risk, currency risk and pipeline penalties from the customers to Avista Energy.

Staff is generally satisfied with the current Benchmark Mechanism for three reasons: customers have paid a reasonable price for the fuel they have used; customers have benefited from storage and off-system sales; and reliability has not been sacrificed. However due to increased market volatility, the Company has proposed changes to the Benchmark Mechanism that will overall reduce risks to both Avista Energy and customers while giving the customers increased price stability and opportunity to share in off-system sales.

COMPANY-IDENTIFIED PROBLEMS AND SOLUTIONS

Even though Staff and the Company have been generally satisfied with the current Benchmark Mechanism, the Company has addressed a few problems in its Application. These problems and proposed solutions are outlined below:

[2] See Order No. 27908 for Case No. WWP-G-98-04 for more details.

1) Avista Energy's cost and risk of managing gas procurement for customers have increased significantly during the past year.

Avista proposes to shift some risk of significant price fluctuations from Avista Energy to customers by using day-of pricing in the commodity component, rather than first-of-the-month pricing, to supply abnormally high or low usage. This proposal would shift risk to customers for approximately 6% of their gas purchases.

2) Customers are experiencing an increased level of gas cost volatility and risk.

Under the Company's Application, Avista Energy would implement a hedging program to reduce customers' level of gas cost volatility and risk. The proposed hedging in the commodity component would fix the price of approximately 40% of customers' gas.

3) Storage could be used more effectively.

Through the proposed commodity and storage components, the Application proposes that Avista Energy would accelerate the storage withdrawal schedule to supply base load in the winter months and use storage to meet the extreme peak loads.

4) An incentive mechanism is necessary to encourage Avista Energy to take greater advantage of off-system sales and capacity releases for customers.

Avista Energy would reduce the fixed credit amount from approximately $2 million to approximately $1 million and implement a sharing mechanism for customers' off-system sales and capacity releases.

PROGRAM DESCRIPTION AND ANALYSIS

Commodity Component (Pricing Structure)

The commodity component establishes the methods and price for purchasing customers' gas. Natural gas used by customers is currently priced at the first-of-the-month published indices

in the following percentages: 50% AECO (Alberta Gas), 25% Sumas (British Columbia Gas), and 25% Rockies (Domestic Gas).

The first-of-the-month indexed prices limit customers' price exposure to once a month market risk. However, the customers' varying daily gas usage subjects Avista Energy to market risk daily. Both the Company and Staff believe the level of risk associated with the current Benchmark Mechanism is unacceptable given the level of price increases experienced by customers over the past year. Avista Energy has also indicated that the Benchmark Mechanism must be modified to eliminate its exposure to differences between first-of-the-month and daily market prices.

The Company now proposes splitting the commodity component into four tiers to adjust the risk exposure of customers and Avista Energy. Customers' risk is reduced through the use of hedges and by an improved use of storage; Avista Energy's risk is reduced by hedging a large portion of the gas requirement and shifting some of the daily price risk to customers.

The proposed program establishes four tiers using customers' daily usage probability for each month and the established volume purchased under the hedging program for threshold amounts. The following is an outline of the tiers and estimated purchase volumes:

Tier	Purchase/Pricing Method	Percentage of Annual Volumes	Daily Volume Usage Probability[3] Interval
Tier 1 (Fixed Amount)	Storage Hedge Total	8.60% 40.37% 48.98%	
Excess Tier 2 Gas (Lower Than Normal Usage)	Spot / Gas Daily	-1.80%	Between Fixed Quantity and 30%
Tier 2 (Normal Usage)	Spot / First of the Month	48.44%	30%-70%
Tier 3 (Greater Than Normal Usage)	Spot / Gas Daily	3.98%	70%-95%
Tier 4 (Much Greater Than Normal Usage)	Stored Gas	0.41%	Above 95%

Tier 1

Tier 1 represents the hedging and storage that comprises approximately one-half of customers' gas. The Company proposes maximizing the use of storage and implementing the hedging program in Tier 1 of the commodity component. More specifically, Avista suggests improving use of its storage[4] by adjusting the synthetic storage injection and withdrawal schedule. The schedule adjustment would take greater advantage of the Company's storage peaking capabilities by accelerating the withdrawal schedule and shifting greater use of storage to peak months. The Company believes that the new schedule would allow them to take greater advantage of summer/winter price differentials. The following is the synthetic schedule for storage injection and withdrawals.[5]

[3] Probability used throughout the Mechanism is the percentage chance that daily demand will not exceed the published daily gas usage volume. The published daily gas usage volumes and associated percentages were determined based on the past five years historical daily usage for each month and its standard deviation. These values are published as part of the tariff and would be adjusted annually.
[4] 8.60% of the annual gas usage is provided from storage.
[5] Injections are indicated as positive and withdrawals are indicated as negative, all values are in dekatherms.

Month	Existing Schedule	Proposed Schedule
January	(850,000)	(860,000)
February	(500,000)	(810,000)
March	(300,000)	(100,000)
April	(100,000)	----------
May	260,000	260,000
June	600,000	610,000
July	600,000	610,000
August	600,000	610,000
September	390,000	390,000
October	---------	----------
November	(100,000)	(100,000)
December	(600,000)	(610,000)

The proposed hedging program in Tier 1 would effectively fix the price of 40.37% of all natural gas purchased for customers. Avista Energy would procure the hedges at no additional cost to customers from the market or utilize its own market-competitive hedge products. In discussions with the Company, Staff proposed that the purchases be systematic to take advantage of dollar cost averaging yet allow sufficient flexibility to preclude competitors from timing Avista's hedge purchases and raising prices. In response, the Company proposed using a series of 30-60 day windows to purchase a minimum amount of hedges and allowing Avista Energy to increase the number of hedges purchased in any window to take advantage of the market when it is appropriate. Staff believes this type of purchasing methodology is necessary to ensure a market-disciplined approach and avoid reliance on market timing to fix the price of gas.

Together, the storage and hedge components of Tier 1 would completely eliminate upside volatility risk to customers on 48.98% of their gas. However, customers would still be exposed to price risk if prices fall in the period between when the price is fixed and when the commodity is consumed. Even with this downside price risk, Staff believes customers would benefit from the stability the program would provide. Staff recommends implementation of the Company's proposed Tier 1 storage injection/withdrawal schedule and the proposed hedging volume in Tier

1. Staff further recommends that the Company file a hedging purchase schedule that will incorporate Staff's recommended purchasing strategy.

Tier 2

Tier 2 prices the normal purchase of gas necessary to meet daily loads beyond Tier 1's fixed volumes. Tier 2's proposed natural gas pricing methodology is the same as the existing methodology. Gas is priced at the first-of-the-month published indices on the existing schedule. If every day fell within +/-20%[6] of the normal usage range, all gas exceeding the amount hedged would be purchased in Tier 2.[7] However, since natural gas usage often varies from the norm, the Company estimates 48.44% of all gas would be purchased within this tier. Staff recommends approval of the proposed methodology for Tier 2.

Excess Tier 2 Gas

To ensure reliability, Excess Tier 2 Gas is the volume of gas purchased greater than Tier 1's fixed amount, but less than the daily volumes included in Tier 2 when usage is less than normal. Avista Energy purchases gas based on monthly forecasts. The minimum amount of gas purchased to ensure reliability is the volume associated with the bottom of Tier 2. On rare occasions, actual gas usage will be less than the minimum Tier 2 volume. When this occurs the Company proposes to charge customers the first-of-the-month price for the minimum Tier 2 volume and credit customers for any excess gas sold at daily market prices. Staff believes that customer impact from this methodology would be small because usage rarely falls below the Tier 2 level and only small amounts of excess gas are likely to be resold.

Tier 3

Tier 3 would provide spot market prices for daily gas purchases when usage is greater than normal. Therefore, this pricing methodology shifts the price risk to customers for purchases made on abnormally cold days.[8] This limits Avista Energy's risk exposure to customers' variable gas usage and maintains the cost of gas management and procurement services at $.05/dekatherm.

The customers' exposure to Tier 3 gas purchases at spot prices higher than first-of-the-month prices is anticipated to be small[9] relative to all gas purchases.[10] Nevertheless, the dollar

[6] 30% to 70% probability
[7] 51.02% of gas would be purchased in Tier 2 if a normal year occurs.
[8] Between 70% and 95% probability.
[9] $313,129 in the last 2 years.
[10] Over $14 million in the last 2 years.

value of such purchases could nearly equal Avista Energy's proposed total service fee,[11] which creates a risk that Avista Energy is not willing to absorb.

Staff determined that the highest risk associated with Tier 3 during the last 3 years was about $300,000. The cost for Avista Energy to retain this risk or to purchase additional hedges to eliminate this risk approached $1 million. Given the relatively modest management fee and the potential impact on Avista Energy of absorbing such risk, Staff believes it is reasonable to price gas in this tier based on the daily market. Staff further believes that it is unreasonable to mitigate a $300,000 risk by spending $1,000,000. Therefore, Staff recommends approval of the Tier 3 methodology.

Tier 4

On extremely cold days when usage is much greater than normal, Tier 4 would allow the use of stored gas when it is less costly than spot market purchases. Tier 4 allows customers to benefit from peak price shaving for high daily gas usage[12] by improving the use of storage. During these extreme high-use periods, gas would be drawn out of storage to meet the peak requirements and any subsequently scheduled storage withdrawals would be reduced accordingly. Customers are likely to benefit more from the extreme day withdrawals than they would be harmed from smaller withdrawals over the remaining average days.

Theoretically, if customers' usage were extremely high, market forces would cause prices to rise. However, the Company has stated that it does not always follow that market prices peak on extreme high-use days. Therefore, Staff believes that even on peak days, the Company must make the appropriate economic decision whether to withdraw from storage in Tier 4 or use the more cost-effective market supply. Therefore, Staff recommends approval of Tier 4 pricing methodology with the additional requirement that storage gas should be withdrawn for peak shaving only when it is economically reasonable, i.e. the lowest cost gas, be it from market or storage, must be used.

Capacity Release and Off-System Sales

The Company maintains sufficient transportation capacity to meet its peak day requirement at the Benchmark basin percentages. Although this amount of transportation capacity ensures a reliable gas delivery system, it also dictates that the Company will have

[11] $363,600, Staff's 2002 Estimate.
[12] Usage in excess of 95% probability.

excess transportation on most days. As a result, the Company is continually looking for ways to gain value out of the excess capacity.

Based on the monthly forecast, the Company often enters into capacity release contracts for the forward month. Customers are credited the value of these temporary contracts. Avista Energy then further refines the forecast and gains additional customer value out of the transportation capacity through basin arbitrage opportunities and buy/sell agreements with third party customers. In the existing program, customers were given a guaranteed amount each month for capacity releases and off-system sales based on the value achieved in the two years prior to the Benchmark Mechanism. This amounted to approximately $2 million per year in guaranteed benefits. Although the Company is proposing to lower the amount of guaranteed benefit from approximately $2 million to approximately $1 million, it offers to increase customers' opportunity to benefit from large arbitrage opportunities and share the resulting revenues with Avista Energy.

The Company believes that a change in the guaranteed capacity release and off-system sales amount is necessary. Customer growth and changes in available pipeline capacity will lower both the amount of Company-owned excess transportation capacity and the market value of that capacity. A change is also necessary to allow customers to benefit from market fluctuations. Last years' market volatility and basin spreads enabled Avista Energy to gain over $3 million in off-system sales during November and December of 2000. If the proposed system was in place at that time, customers would have gained approximately $2.4 million and Avista Energy only $600,000.

The Company proposes a guaranteed benefit of approximately $1 million, or one-half of the current guaranteed amount. It further proposes a sharing (80% customers, 20% Avista Energy) of the remaining capacity releases and off-system sales once the fixed benefit is fulfilled. With this proposal, Avista Energy would have an incentive to find the best off-system sales opportunities for customers. Customers would also have a much greater potential for higher revenues should Avista Energy succeed and markets continue to provide greater arbitrage opportunities. Therefore, Staff recommends approval of the proposed changes to capacity releases and off-system sales.

Contract Modification and Termination

The Company proposes a three-year contract that would become effective April 1, 2002 and renew automatically on an annual basis thereafter unless either party (Commission or

Company) provides a 6-month notice of termination. Staff recommends approval with the following contract revisions:

1) Seven months prior to the contract's termination on March 31, 2005, the Company shall file an analysis of the Benchmark program detailing the costs and benefits to customers, to the Company and to Avista Energy. The reports shall also include any recommended changes or modifications that the Company may have to the Benchmark Mechanism.

2) After analyzing the first year results and/or obtaining a final ruling by the Washington Commission, the Idaho Public Utilities Commission shall have an opportunity to review and modify the Benchmark Mechanism as necessary.

3) Staff does not accept the contract renewal provision because the Commission should have an opportunity to review and adjust the program prior to its automatic extension. It would also allow the Idaho Commission to react to changes that may occur as a result of other regulatory action. However, the Company may request continuation of the Benchmark Mechanism at the time of the review seven months prior to termination on March 31, 2005.

4) The hedging program shall include provisions to facilitate the three previous recommendations.

STAFF RECOMMENDATIONS

In general the proposed changes provide additional benefits to customers without increasing direct costs. Staff recommends approval of the changes requested by the Company with the following additions and modifications:

1. Staff recommends implementation of a risk management committee and better documentation of the decision-making process. As is evident by the proposed commodity component, Avista no longer purchases gas for its customers in a simple, transparent manner. With the implementation of the hedging program, it will be important to have a risk management committee (RMC). This risk management committee should consist of members from the utility and its affiliate, Avista Energy. The RMC should act in the best interest of the ratepayers. It should also meet on a regular basis to plan, prepare for and execute a gas procurement program that will benefit customers. The Commission and the Company must also enter a new period of communication and documentation. The Company must be willing to provide the Commission greater information to assure customers that the Company is using all available expertise to

optimally minimize natural gas procurement costs. Staff recommends that the Company retain the following information:

- All graphs, visuals and charts used in discussions to make gas procurement and hedging decisions;
- Articles, letters, memos, reports, notes, etc. detailing the current gas market and/or projections;
- Summary of risk management meetings between the utility and Energy, and
- Written decisions resulting from each risk management meeting that are signed by a corporate officer.

Staff will gladly work with the Company to discuss and develop this recommendation. Staff will review the initial documentation retained in the coming months to informally discuss the process and make additional recommendations for the Company to consider.

2. Staff recommends that storage be withdrawn for peak shaving only if it is economically reasonable under Tier 4 of the commodity component.

3. Staff recommends the following changes to the Benchmark Contract:

A) Seven months prior to the contract's termination on March 31, 2005, the Company shall file an analysis of the Benchmark program detailing the costs and benefits to customers, to the Company and to Avista Energy. The report shall also include any recommended changes or modifications that the Company may have to the Benchmark Mechanism.

B) After first year analyzing results and/or a final ruling by the Washington Commission, the Idaho Public Utilities Commission shall have an opportunity to review and modify the Benchmark Mechanism as necessary.

C) Staff does not accept the automatic renewal provision. However, the Company may request continuation of the Benchmark Mechanism at the time of the review seven months prior to termination on March 31, 2005.

D) The hedging program shall include provisions to facilitate the three previous recommendations.

4. Staff recommends that the Commission continue to reserve the right to audit the books, operations and records of Avista Energy as it does with the current Benchmark Mechanism. This is important to ensure that the Benchmark is a reasonable method of gas procurement.

5. Staff recommends that the Company continue to file quarterly reports that provide details of gas purchases, off-system sales, hedging activities and other Benchmark-related items.

6. The Company shall file a hedging schedule in accordance with Staff recommendations prior to securing hedges.

7. Staff recommends that the Company and Avista Energy continue to abide by the Standards for Competitive Practices. The Company shall continue to make nominations for transportation customers to ensure that market sensitive information is not passed on to its affiliate, Avista Energy.

Respectively submitted this day of January 2002.

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