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IDAHO PUBLIC
UTILITIES COMMISSION

AVISTA
Corp.

August 30, 2004

Idaho Public Utilities Commission
472 W. Washington Street
Boise, ID 83702

AVU-G-03-2

Attention: Jean D. Jewell
Re: Avista Utilities Natural Gas Benchmark Mechanism Summary Evaluation Report.

Pursuant to Commission Orders No. 28941 and 29557 Avista Corporation (hereafter, Avista Utilities or the Company) hereby submits an analysis of the Natural Gas Benchmark Mechanism (Benchmark Mechanism). This report includes information related to the operation of the Benchmark Mechanism, from its inception through June 30, 2004. This report also addresses the impact on Idaho customers of the termination of the Benchmark Mechanism.

Background:

Avista Utilities and Avista Energy have had an agency agreement in place since the fall of 1999, which calls for Avista Energy to provide natural gas supply management services to Avista Utilities. These services are regulated by the Idaho Public Utilities Commission (IPUC or Commission) under Tariff Schedule No. 163 "Natural Gas Benchmark Mechanism." The structure of the Benchmark Mechanism was modified in 2002 and the current tariff is effective through March 31, 2005.

The Commission's Order No. 28941, dated February 1, 2002, specified the reporting to be provided to the Commission related to the Benchmark Mechanism:

"....the Company shall file an analysis of the benchmark program detailing the costs and benefits to customers, to the Company and to Avista Energy seven (7) months prior to the contract's termination on March 31, 2005. The report shall also include any recommended changes or modifications that the Company may have to the Benchmark Mechanism." (Page 7)

In addition, in the Commission's Order No. 29557, in Case No. AVU-G-03-2, related to Avista Utilities' Integrated Resource Plan, the Commission ordered that:

"...the company is directed in its August 31, 2004 Schedule 163 Benchmark Program status report filing (Case No. AVU-G-01-3) to address the WUTC Benchmark Incentive Mechanism order, the Company's transition plan, and the related regulatory consequences and economic and operational ramifications in Idaho of terminating the Benchmark Program." (Page 3)

On February 13, 2004, in Docket No. UG-021584, the Washington Utilities and Transportation Commission (WUTC) issued an order terminating the Benchmark Mechanism in the state of Washington, and requiring Avista Utilities to file a transition plan to move the natural gas procurement functions from Avista Energy back into Avista Utilities. The transition plan filed by Avista Utilities, and approved by the WUTC, calls for the gas procurement functions to be moved back to the Utility by March 31, 2005. This date coincides with the term of the Benchmark Mechanism approved by the IPUC and the Oregon Public Utilities Commission (OPUC) of March 31, 2005.

During the transition period there will be no additional costs to Idaho customers. The attached analysis indicates that moving the procurement functions back to the utility will result in an increase in annual costs of approximately \$200,000 to \$400,000 for Idaho customers. This increase in costs is related primarily to an increase in labor costs at the Utility, an increase in credit (collateral) costs, and the loss of benefits currently being provided by Avista Energy under the Benchmark Mechanism.

Please direct any questions related to this filing to Liz Andrews at (509) 495-8601.

Sincerely

Kelly Norwood

Kelly Norwood
Vice President, State and Federal Regulation

Encl.

Idaho Benchmark Mechanism Report

I. Summary of Costs and Benefits

The costs and benefits to Idaho customers have been reported quarterly since the Natural Gas Benchmark Mechanism (Benchmark Mechanism) began in September 1999. While the precise difference in total benefits between the Utility managing the portfolio and Avista Energy managing it is difficult to quantify, an estimate of the cost to return the Benchmark Mechanism back to the Utility is included later in this report under the section entitled "III. Impact of Benchmark Mechanism Termination." That analysis, which includes estimated costs for such expenses as employee labor, credit, load volatility, etc., shows that the estimated total cost to Avista Utilities' Idaho customers of returning the gas procurement functions back to the Utility ranges from $200,000 to $400,000 annually.

A copy of the Benchmark Mechanism Quarterly Summary Reports previously provided to the Idaho Public Utility Commission (IPUC) for the two-year period ending June 2004 is provided as Attachment II.

II. Net Loss to Avista Energy During the Benchmark Mechanism

Avista Energy's actual operation of the Benchmark Mechanism (September 1999 through February 2003) has netted an average annual loss of approximately $428,000. This average loss was driven primarily by events in 2000 from the unprecedented high prices that occurred in the market. During this time period, Avista Energy was at risk for the intra-month volatility in market prices. As intra-month prices rose to unprecedented levels during November-December 2000, Avista Energy absorbed these costs compared to first-of-the-month index, and customers benefited significantly.

III. Impact of Benchmark Mechanism Termination

With the expiration of the Benchmark Mechanism on March 31, 2005, Avista's analysis indicates that moving the gas procurement functions back to the Utility will result in an increase in costs ranging from $200,000 to $400,000 annually for Idaho customers. Described below are the components of this analysis.

(1) Employee labor and other related costs - Includes Idaho allocation of the cost of adding 5 personnel to the Utility: Director, Gas Supply; Gas Buyer, Capacity Release specialist, Scheduler and a resource accountant, plus other costs such as computer equipment, etc. Idaho's share totals approximately $142,000 annually.

(2) Credit Facility – In May 2004, the Company's line of credit was amended to increase the available amount from $245 to $350 million in order to accommodate, among other things, increased credit requirements for additional gas purchases by the Utility. Idaho's share of the cost to increase the credit facility for the Utility (approximately $36,600) plus the additional cost of posting $10 Million in LC's @ 150 basis points ($150,000) for Idaho's volume, totals approximately $186,600 annually.

(3) Premium for Physical Delivery – The calculated premium for physical delivery was based on an index market analysis of the three basins from November 2002 to October 2005. The weighted average index for the premium was $0.0073 per Dth. Idaho's estimated volume of 7.2 million Dth x .0073 totals $52,500 annually.

(4) Currency risk – Currency Risk has been estimated at $0.01 per Dth. The AECO market trades almost exclusively in Canadian Dollars. The Utility assumes the risk of supplying this gas to a US $ market of $0.01 per Dth x Idaho's volume of 7.2 million Dth totals $72,000 annually.

(5) Load Volatility –Represents Idaho's pro rata share of the estimated cost/benefit to cover load volatility. The cost of covering load volatility in any gas portfolio is difficult to quantify. Satisfying load volatility includes several components. Under the Benchmark Mechanism in Idaho, Avista Energy utilized the benefits of basin optimization to offset the cost of guaranteeing the load swings (volatility) within tier 2 at First of Month index cost. Historically, this number has ranged from a benefit to customers, due to the high price period in 2000, to a net cost to customers. The historical numbers have varied greatly due to the energy crisis in 2000, and changes in the market including volatility of loads, as well as changes to the mechanics of the Benchmark Mechanism. Accordingly, the Company has estimated that the expectation going forward for the Utility to cover load volatility is a net benefit to customers ranging from $400,000 to $600,000 annually.

(6) Estimated Loss of Transportation Benefits – This is Idaho's pro rata share of the estimated loss in Capacity Release/Off System Sales benefits provided by Avista Energy which totaled approximately $700,000 annually.

(7) Adder component: The $0.05 adder per Dth component, which was paid to Avista Energy in order to cover a portion of the above listed expenses, totaled approximately $360,000 annually based on Idaho's estimated volumes. With the return of the gas procurement functions back to the Utility, this expense for the Utility will terminate and therefore is a benefit to customers.

Supporting workpapers are provided with this report.

IV. Post Transition Strategy:

Following the transition of the natural gas procurement functions back to Avista Utilities, the Utility will manage its gas portfolio in a structured format similar to the structure that is in place with the Benchmark Mechanism. Physical purchases will be a mix of first of month index purchases, fixed price term contracts for winter and annual supply and efficient storage management to capture winter/summer price differentials. Storage will also be utilized to assist in daily balancing and mitigation of high cost day pricing.

The Utility will continually monitor market trends and review the most effective mix of fixed and index pricing and storage management to provide the best pricing scenario for customers, balancing between price stability, supply reliability and current market. The company believes that the structure established under the Benchmark Mechanism is a fundamentally sound portfolio management structure. Transition Plan

Because gas purchasing as well as the transportation asset management function for all three states (ID, WA, OR) is handled as one pooled portfolio it is not practical to separate one state from the others. To do so results in inefficiencies for all states because of the administrative burden and the inability to separate the transportation and storage assets and still capture the load diversity associated with serving customers across a broad geographic area. The transition plan approved by the WUTC calls for Avista Energy to continue to manage the natural gas procurement functions for Avista Utilities until March 31, 2005 under the following terms: 1) there is no sharing of costs and benefits between Avista Energy and Avista Utilities' customers during the transition period – 100% of the costs and benefits are assigned to customers; 2) although Avista Utilities will consult with Avista Energy regarding natural gas procurement, the decisions will be made by Avista Utilities, and the transactions executed by Avista Energy; and 3) Avista Energy receives $75,000 per month during the transition period for the service provided. Avista Utilities is currently in the process of hiring additional personnel in order to return the gas supply management function to the utility by April 1, 2005.

V. Transition Documents

The Commission's order in Case No. AVU-G0-03-2 directed Avista to provide Commission Staff with copies of all Benchmark Mechanism Transition documents submitted in the Company's other jurisdictions. All Benchmark Mechanism Transition documents submitted to other jurisdictions have been previously submitted to Idaho Commission Staff. An additional copy of the Transition Plan as filed with the WUTC is included with this filing as Attachment I.

VI. Transition Activities and Goals:

Numerous activities related to the transition have already occurred at the Utility including those summarized below.

1) Gas Acquisition During Transition:

- Several meetings have occurred with Avista Energy related to purchasing strategies for both physical gas and financial hedges for the upcoming year.
- The Utility has an employee on the Avista Energy trading floor each morning to observe and capture the terms on deals done for the utility.

2) Credit Facility:

- In May 2004, the Company's line of credit was amended to increase the available amount from $245 to $350 million in order to accommodate increased credit requirements for additional gas purchases by the Utility.

3) Personnel:

- The utility has added a position in Resource Accounting to assist with the additional workload of the transition and post transition period.
- A search is underway to fill the position of Director of Gas Supply. This will be an addition to the Utility's gas supply department that will enhance the level of skill sets with respect to gas acquisitions, portfolio management and will assist with staffing at the Utility.
- Other staffing which is needed to reinforce the scheduling team, gas purchasing and transportation asset management will be finalized with the assistance of the new Director.

4) Counterparty Contracts:

- The Utility has been expanding its supplier list by adding master agreements for gas purchases and sales with numerous third party suppliers.

5) Other Transition Activities;

- Both the Utility and Avista Energy have been preparing lists of activities that need to occur prior to transition, for example, notification of all suppliers that Avista Energy will no longer be acting as agent for the Utility. The list also includes changing the agency delegation for Avista Energy's nomination and scheduling on all pipelines that have contracts with the Utility.

IDAHO BENCHMARK MECHANISM REPORT

ATTACHMENT I

TRANSITION PLAN

Avista Utilities
Washington Transition Plan for Benchmark Mechanism

Introduction:

1. Under the proposed Transition Plan, the Natural Gas Benchmark Mechanism (Benchmark Mechanism) and Schedule 163 would terminate effective April 30, 2004. For accounting purposes it will be important to terminate at the end of a calendar month.

2. With regard to the Transition Plan, the Commission stated in its Order at paragraph 89 that:

   > "... it acknowledges the Idaho and Oregon arrangements, leaving room for discussions of parties that develop a transition that coordinates with other Avista operations and provides the least disruption to the company and its ratepayers."

   In addition, the Commission stated at paragraph 91 and again at paragraph 111:

   > "In developing the schedule for transition, the parties may consider that the Mechanism as it currently exists in Oregon and Idaho expires in March 2005. The Commission will consider a further extension of the expiration date, if necessary, depending on the plan we approve for transition of the Mechanism."

3. Recognizing that the Transition Plan should be one that "provides the least disruption to the company and its ratepayers," the proposed Plan would terminate the Benchmark Mechanism in Washington in the near-term, while attempting to avoid the inefficiencies during the Transition Period associated with having part of the procurement functions at Avista Energy (Idaho and Oregon) and part of the functions at Avista Utilities (Washington). To illustrate this point:

   a. With regard to transportation (especially), if the execution of transactions were to be immediately transferred back to the utility, the utility does not yet have trained staff in place, nor does the utility have adequate counterparty contacts to properly optimize available pipeline transportation through capacity releases and off-system sales. The proposed Transition Period would provide time to hire additional staff and train them, so that they would be fully prepared to begin execution at the end of the Transition Period.

   b. The staff positions necessary to perform the natural gas procurement functions require highly trained individuals with respect to the natural gas commodity markets, pipeline transportation systems, the utility's specific system, available storage facilities and related requirements, and the utility's retail loads for each season of the year, among other things. It will likely take a minimum of several months to identify, interview and hire these individuals, and additional months to train them on Avista's system and load characteristics. During the Transition Period one or more of the utilities' employees would be located with Avista Energy in order to train them in the operations and prepare them for the April 1, 2005 transfer.

c. The transportation assets and supply portfolio are operated as a pool to gain efficiencies. If the Washington operations are separated from the Idaho/Oregon operations, it would result in inefficiencies and increased costs to customers. For example, the demand diversity across Avista's whole system allows the Company to project a system peak day that is lower than the sum of the design peak in each state, because the peak day does not occur on a coincident basis. As a second example, the pipelines allow the Company to consolidate system imbalances for all states.

Details of Proposed Transition Plan:

4. Termination of Schedule 163 and the Benchmark Mechanism: The current Benchmark Mechanism and Schedule 163 would terminate effective April 30, 2004. The proposed Transition Period would be May 1, 2004 through March 31, 2005. During the proposed Transition Period, the Utility would continue to consult with and draw on the expertise of Avista Energy, however, the management and decision-making related to the natural gas procurement functions would reside with Avista Utilities, under the Manager of Gas Supply. The execution of transactions would be conducted by Avista Energy. There would be no incentive-sharing (i.e., 80%/20%). All costs and benefits associated with commodity, Jackson Prairie (JP) Storage, transportation and basin optimization would go to Avista Utilities' customers. Avista Energy would only receive a management fee to cover a portion of the costs it occurs in providing this service during the Transition Period, as set forth below.

5. Incentive Sharing Eliminated: No Sharing of costs or benefits by Avista Energy, including:

   a. No sharing of benefits associated with:
      i. Commodity transactions, including basin optimization;
      ii. Storage summer/winter differential; and
      iii. Transportation – Capacity Release/Off-System Sales.

   b. No sharing of costs associated with:
      i. Intra-month load and price volatility; and
      ii. Miscellaneous risks, e.g., currency, premium for physical delivery, nomination errors, counter-party risk, operational flow orders or entitlement.

6. Commodity: Under Avista Utilities' direction, Avista Energy would purchase a portion of the Utilities' natural gas requirements months in advance, some at first of month (FOM) index, along with daily purchases and sales (including basin optimization) and the use of storage to balance load. The decision to use storage to cover load versus purchasing from the daily market would be made by Avista

Utilities. All costs and benefits associated with the commodity costs to serve the utility's load, including basin optimization, would be billed or credited to utility customers.

7. Storage: Under Avista Utilities' direction, Avista Energy would inject and withdraw storage providing the winter/summer price differential and reliability of peak day demand coverage. All costs and benefits associated with the storage transactions would be billed or credited to utility customers.

8. Transportation: Under Avista Utilities' direction, Avista Energy would optimize available pipeline transportation through capacity releases and off-system sales. All costs and benefits associated with these transactions would be billed or credited to utility customers.

9. Management Fee: Avista Utilities would pay Avista Energy a management fee of $75,000 per month during the Transition Period for the services provided, which would be included in the PGA costs. The purpose of the fee would be to compensate Avista Energy for a portion of their costs such as employee labor and associated support costs and credit and banking costs, as shown in the table on Page 32 of the Commission's Sixth Supplemental Order.

10. Training/Misc.: During the transition period, Avista Utilities would complete the tasks necessary to bring the gas procurement functions back within the utility, i.e. hiring and training of employees, pipeline, storage and third party supplier notifications of change in contract relationships, development and documentation of internal administrative procedures, etc.

11. Other Jurisdictions: The Benchmark Mechanism terminates in Idaho and Oregon March 31, 2005. Effective April 1, 2005 execution of natural gas procurement services for all three states (Washington, Idaho and Oregon) would revert to the utility.

ATTACHED REPORTS IN CASE FILE AVU-G-03-02

AND ALSO IN AVU-G-01-03