DECISION MEMORANDUM

TO: COMMISSIONER KJELLANDER
COMMISSIONER SMITH
COMMISSIONER HANSEN
COMMISSION SECRETARY
COMMISSION STAFF

FROM: DONOVAN E. WALKER

DATE: OCTOBER 21, 2005

SUBJECT: AVISTA'S 2005 PGA – CASE NO. AVU-G-05-2

On September 12, 2005, Avista Utilities (Avista, Company) filed its annual Purchased Gas Cost Adjustment (PGA) Application with the Idaho Public Utilities Commission (Commission) requesting authority to place new rate schedules in effect as of November 1, 2005 that will increase its annualized revenues by $15.7 million (23.8%). The PGA mechanism is used to adjust rates to reflect changes in the costs for the purchase of gas from wholesale suppliers including transportation, storage, and other related costs of acquiring natural gas. The Company contends its earnings will not increase as a result of the proposed changes in prices and revenues.

The Commission issued a Notice of Application and Modified Procedure on September 29, 2005, establishing a comment deadline of October 20, 2005. Order No. 29876. Pursuant to Rule 125, IDAPA 31.01.01.125, Commission Staff conducted a public workshop in Coeur d'Alene on October 11, 2005. Written comments were received from several customers as well as from Commission Staff.

THE APPLICATION

According to Avista's Application the Company requests an increase in its annual revenue of approximately $15.7 million or about 23.8%. This would result in the average residential customer who uses 70 therms per month to see an estimated increase of $16.36 per month.

Avista states that it purchases natural gas for customer usage and transports this gas over various pipelines for delivery to customers. The Company defers the effect of timing differences due to implementation of rate changes and differences between the Company's actual

Weighted Average Cost of Gas (WACOG) purchased and the WACOG embedded in rates. Avista also defers the revenue received from the release of its storage capacity as well as various pipeline refunds or charges and miscellaneous revenue received from gas related transactions.

The Company requests an increase in the prospective natural gas cost component included in the rates charged to customers by 21.443 cents per therm. This consists of an increase of 21.047 cents per therm related to the commodity cost of purchasing and transporting gas for customer usage and an increase of .396 cents per therm related to fixed pipeline costs.

Avista requests an increase in the present WACOG from 55.739 cents per therm to 76.786 cents per therm, an increase of 21.047 cents. This reflects first-of-the-month (FOM) forward gas prices as of August 4, 2005, and the Company's hedges executed to date. The Company executes hedges to fix the price of gas on approximately 50% of its estimated annual gas sales for the year, and uses a dollar-cost averaging approach for executing hedges, with those volumes divided into 45-day execution windows between February 15 and November 15. The Company states that it has completed approximately 80% of its scheduled hedges for the upcoming PGA year, November through October.

The Company is also proposing a change in the present amortization rate, which is used to refund or surcharge customers the difference between actual gas costs and projected gas costs from the last PGA filing over the past year. Avista proposes to increase the amortization rate from the present surcharge of 3.093 cents per therm to 5.027 cents per therm. The Company states it has a deferred gas cost balance of approximately $3.5 million as of June 30, 2005, reflecting higher gas costs than projected during the past year. The proposed increase in the amortization rate is expected to recover this balance over 12 months.

The Company states that notice of its proposed increase in price has been accomplished by posting a notice at each of the Company's district offices in Idaho, a press release distributed to various informational agencies, and a separate notice to each of its Idaho gas customers included in their billing. Avista attached copies of these notices to its Application.

STAFF COMMENTS

Staff has reviewed the Application, performed an audit of gas purchases and reviewed additional information supplied by the Company and third parties. In analyzing Avista's proposal, Staff discussed: (1) market prices and factors affecting the WACOG; (2) the deferred expenses from the previous PGA year; (3) the termination of the deferral due to the

Northwest Pipeline error; (4) the cost of hedges purchased for price stability; (5) the cessation of the Benchmark Mechanism for gas purchases; (6) Avista's gas procurement and risk management policies and procedures; and (7) consumer issues. Staff recommends that the requested increase in the WACOG, and the 12-month amortization of deferred expenses be approved. Staff also recommends that the Company be directed to continue its monthly reporting of the changes to and balances in the deferral accounts, continue reporting the WACOG quarterly, and enhance its documentation of gas hedging.

Staff reviewed the Company's proposed WACOG against other forecasts, including those published weekly by the U.S. Energy Information Administration. Staff notes that this requested increase, reflecting the Company's belief that the cost of gas will continue to rise, is consistent with the forecasted northwest regional cost of natural gas.

Staff stated that the increase in the Company's cost of purchasing natural gas and the price risk that natural gas market volatility poses to consumers in Idaho is driven by factors that have been previously recognized and evaluated by the Commission and Staff. Growing demand combined with long lead times to deliver new production to consumers contributes to the continuing upward price trends. In addition, construction of pipelines that can now deliver natural gas from the Company's natural gas sources to the Eastern United States and California markets in larger volumes than a few years ago contributes to the upward price trends. This increased market access for gas producers creates for the Company the same volatility and price increases as those experienced by other national and world market supplies.

Staff noted that the forward looking WACOG set in last year's PGA was fairly reflective of the market rate until late summer of this year. However, in the past three months, the market indexes for natural gas have been extremely volatile and prices have increased significantly. In August and September the effects on natural gas production of two major hurricanes in the Gulf of Mexico contributed to the volatility. The NYMX price for natural gas peaked recently at $1.48 per therm and is currently in the $1.38 range. These weather factors have exasperated what was already a volatile market with increasing prices.

Staff also noted that Avista uses an amortization rate set forth under Schedule 155 to refund or surcharge customers the difference between actual gas costs and the projected costs allowed in the previous PGA filing. In previous PGA filings, Avista has voluntarily amortized the deferred balance over periods longer than one year to mitigate the effects of price increases on customers. Avista has, in the past, been the only utility company in Idaho to amortize this deferred balance over periods exceeding one year. However, in this current filing, Avista proposes to use a 12-month amortization period because of uncertainty and volatility in the natural gas markets. Staff believes that the 12-month amortization period for deferred balances is appropriate for this case, and recommends accepting the proposed surcharge increase.

Given that natural gas market prices have actually increased since the Company's filing in September, Staff recommends that the requested increase in the WACOG and the 12-month amortization of deferred expenses be approved. Any reduction in the WACOG requested by the Company could expose customers to greater WACOG increases and larger deferred balances next year.

Staff reported that the final payment for gas replacement to correct the Northwest Pipeline meter error, discussed by Staff in last years PGA, *See* Order No. 29590, will be made this month. The additional deferral balance caused by the re-allocation of costs between Idaho and Washington due to the error will be completely removed.

Avista discontinued the use of the Benchmark Mechanism, previously used to purchase gas from its affiliate, Avista Energy, after the Washington Utilities and Transportation Commission ordered it to do so for its Washington customers. Rather than attempting to maintain the Benchmark Mechanism in Oregon and Idaho while eliminating the mechanism in Washington, Avista discontinued using the mechanism in all of its service territories. Staff states that because the system is so intertwined, it could impose an undue burden on Avista Utilities to continue purchasing gas from Avista Energy under the Benchmark Mechanism in Idaho while simultaneously undertaking the tasks of managing the procurement and delivery of gas solely within Avista Utilities for its Washington customers. A backcast analysis using the Benchmark Mechanism will be evaluated to determine if eliminating the Benchmark Mechanism has harmed customers. This analysis will also be used as an evaluation tool for prospective procurement and risk management programs. Management fees were paid and passed through to customers under the Benchmark Mechanism. Avista Utilities will now incur additional salaries and other costs for gas procurement. Staff states that these costs will be fully examined for reasonableness in the next rate case.

Staff believes a risk management program is very important for Avista Utilities and its customers. Staff recognizes that a common approach to gas procurement throughout all of

Avista Utilities' jurisdictions may provide efficiencies that could also benefit customers significantly. Without Avista Energy to make gas purchases under the Benchmark Mechanism agreement for Avista Utilities, Avista Utilities was forced to rapidly implement a new Natural Gas Supply, Procurement and Hedging Policy. At this time, especially with high gas prices and volatility, it is critical for Avista Utilities to expand and formalize its risk management practices. Staff will work with the Company to formalize an acceptable program. Staff has reviewed the initial drafts of the policy and believes the policy takes the first steps to provide for disciplined purchases and hedges without speculation or causing undue risk to customers. However, Staff found little written documentation illustrating that the Company was following its written policies. To avoid second-guessing the reasonableness and prudence of the Company's purchases, adequate documentation surrounding such purchases is required. Enhancing the minutes of the Strategic Oversight Group to include details and surrounding circumstances of large natural gas purchases is a simple improvement that can be implemented immediately without causing an undue burden on the Company.

Staff reported that Avista Utilities shareholders give more to fuel funds on a per-customer basis than any of the other regulated utilities in Idaho. In the past five years, Avista shareholders have given a total of $565,000 to Project Share. In addition to the donations to fuel funds, an agreement was reached last year with Community Action Partnership of Idaho in which Avista agreed to increase its funding for low-income weatherization purposes from $108,000 per year to $350,000 per year.

In summary, Staff recommends that the requested increase in the WACOG, and the 12-month amortization of deferred expenses be approved. Staff also recommends that the Company be directed to continue its monthly reporting of the changes to and balances in the deferral accounts, continue reporting the WACOG quarterly, and enhance its documentation of gas hedging.

PUBLIC COMMENTS

The Commission received comments from approximately 26 customers of Avista as of October 18, 2005. In general, customers' comments focused on continued increases in the cost of natural gas and other necessities without commensurate cost of living increases for those on fixed incomes. Many of those who commented voiced concerns that those who are unable to afford higher heating bills will be forced to go without medications or other necessities. Several references were made to the historical representation that natural gas was an abundant and cheap source of fuel and to utilities efforts to encourage customers to convert to natural gas for space and water heating. Several comments also questioned the Company's earnings and profits and suggested that the shareholders and CEO reduce salaries, expenses, use of the corporate jet, etc. . . . to absorb the increase in gas supply costs.

COMMISSION DECISION

1. Does the Commission wish to approve Avista's Application, including the requested WACOG and amortization of deferred expense as filed by the Company and recommended by Staff?

2. Does the Commission wish to direct the Company to continue its monthly reporting of the changes and balances in the deferral accounts and to continue reporting the WACOG quarterly?

3. Does the Commission wish to direct the Company to enhance its documentation of gas hedging?

Donovan E. Walker

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