DECISION MEMORANDUM

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

FROM: DONOVAN E. WALKER

DATE: OCTOBER 25, 2006

SUBJECT: AVISTA'S 2006 PURCHASED GAS COST ADJUSTMENT (PGA), CASE NO. AVU-G-06-03

On September 14, 2006, Avista Utilities filed its annual Purchased Gas Cost Adjustment (PGA) Application with the Commission requesting authority to place new rate schedules in effect as of November 1, 2006 that would increase its annual natural gas revenues by approximately $2.7 million (3.2%). On September 29, 2006, Avista filed a revised PGA Application and tariff sheets to revise the Company's proposed weighted average cost of gas (WACOG) to reflect a further reduction in wholesale natural gas prices. The revised Application proposes to reduce the Company's estimated annual natural gas revenues by approximately $2.8 million (3.4%).

The Commission issued a Notice of Application and Modified Procedure on October 4, 2006, establishing a comment/protest deadline of October 24, 2006. Order No. 30141. The Commission received comments from seven customers of Avista as well as Commission Staff.

THE REVISED APPLICATION

According to Avista's Application if the requested price decrease is approved the Company's annual revenue will decrease by approximately $2.8 million or about 3.4%. The average residential or small commercial customer using 65 therms per month would see an estimated decrease of $2.70 per month (3.4%).

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

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.

Avista's original Application requested an increase in the WACOG from its present 78.600 cents per therm to 84.712 cents per therm. The revised Application requests a decrease in the WACOG from its present 78.600 cents per therm to 76.244 cents per therm. The proposed WACOG is based on a weighting of forward natural gas prices on September 21, 2006, for unhedged volumes, and the Company's hedges executed to date. The Company generally executes hedges to fix the price of gas on approximately 66% of its estimated annual gas sales for the year, and uses a dollar-cost averaging approach for volumes to be hedged, with those volumes divided into 45-day execution windows between February 15 and November 15. The Company states that it has hedged approximately 60% of its estimated annual gas sales for the forthcoming year. It states it will hedge an additional 20% of the estimated sales within days of the revised Application filing, in order to take advantage of the recent sharp drop in forward gas prices.

This past year the Company began incorporating an amount of longer-term hedges into its purchase portfolio to provide an additional degree of rate stability. Approximately 11% of the total purchases for the next year have been hedged at a three-year fixed price. The Company's plan is to keep layering-in three-year fixed price hedges until these hedges represent one-third of the portfolio going forward. This plan has been incorporated into the Company's Risk Management Policy and provided to Commission Staff.

The Company's proposed rates in this filing also incorporate the proposed rate increases filed by the Company's two main pipeline suppliers, Northwest Pipeline and Gas Transmission Northwest. The proposed pipeline rates, while not yet approved, are set to begin being billed to Avista on January 1, 2007. The Company states that while these pipeline rate increases are substantial, the effect on the Company's proposed rates in this filing is completely mitigated by an increase in the estimated revenue to be received from pipeline capacity releases.

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 decrease the amortization rate from the present surcharge of 5.027 cents per therm to 3.420 cents per therm. The Company states it has an estimated deferred gas cost balance of approximately $2.8 million as of October 31, 2006, reflecting higher gas costs than projected during the past year. The proposed amortization rate of 3.420 cents per therm 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 hedging, and reviewed additional information supplied by the Company and third parties. In analyzing Avista's Application, Staff discussed: (1) the effects of the 2005 hurricane season; (2) the pipeline transportation rate cases pending before the Federal Energy Regulatory Commission (FERC); (3) the Company's proposed WACOG and its hedging policies; (4) the cessation of the Benchmark Mechanism for gas purchases; and (5) customer issues.

Staff recommends that the Commission approve the Company's revised Application and filed tariffs reducing Avista's annual revenue by approximately $2.8 million. Staff also recommends that the Company be directed to file further tariff decreases if the forecasted WACOG decreases materially or if the result of the pending FERC pipeline rate cases result in transportation expenses significantly less than what the Company has included in its proposed tariffs.

Staff comments that the deferred balance subject to recovery in this case was larger this year mainly because of the fact that the large price spikes caused by the disruption of gas supply in the Gulf of Mexico as a result of Hurricane's Rita and Katrina were not anticipated in the Company's approved WACOG. The deferral balance was lower than the previous year, and would have been lower still had it not been for unusual effects of the Hurricanes.

Avista's proposed prices are weighted to account for the January 1, 2007 effective date of the proposed price increases of the Northwest Pipeline Corporation (NPC) and Gas Transmission Northwest (GTN), both of which have pending rate cases before the FERC. Staff recommends that the methodology used by Avista to determine the annual impact of the pipeline rate increases on the total cost of service is appropriate, as it aligns transportation increases with the purchased gas cost adjustment during the PGA year in which the increases will occur.

Because both pipeline case increases are subject to FERC approval as well as negotiations between the pipelines and their customers, Staff recommends that, in the event that the FERC approved rate increases are significantly lower than what Avista has included in its proposed tariffs that the Company be directed to file for additional decreases.

Staff reviewed the Company's proposed WACOG of $0.76244 per therm against other forecasts, including those published weekly by the US Energy Information Administration, and recommends that it is consistent with the forecasted northwest cost of natural gas. Staff states that although use of this forward pricing is aggressive and has the potential, if prices are higher, to result in a large deferral balance to be recovered next year, that the Company has all ready been able to take advantage of lower prices and hedged a larger amount of gas for the 2006-2207 season. Recent sharp drops in forward prices have allowed the Company to hedge approximately an additional 20% of its forecasted load at lower prices. If prices continue to drop, Avista plans to execute additional hedges beyond the 80% of forecasted demand.

Avista continues to follow its price stabilization practice of systematically fixing portions of gas costs using physical hedges and financial instruments in a time staggered purchasing procedure aimed at achieving a diversified portfolio of purchases and hedges. The Company hedges up to its estimated daily demand each month with a combination of fixed prices gas purchases and scheduled withdrawals from available storage. Typically, these hedges total approximately 66% (2/3) of the Company's forecasted loads, although, as mentioned above, for the forthcoming PGA year, the hedges total nearly 80% of forecasted load to take advantage of recent price drops.

For the period from July 1, 2005 through September 30, 2006, the Company's hedging practices, including storage withdrawals, provided a benefit to customers of approximately $2,766,874. This benefit was quantified by comparing the hedged price to the First of Month (FOM) index price and the difference was multiplied by the hedged volume.

During the past eight months the Company has pursued its revised gas procurement program whereby 11% of supply is now purchased at a fixed price three years in advance. Under this plan the Company will purchase 11% of its supply on this three-year term to result in a total of 33% of supply being purchased three years in advance, attempting to achieve more price stability for customers. Staff continues to work with the Company to evaluate this methodology and develop other hedging and purchasing practices with the intent of both stabilizing and reducing gas costs.

As reported last year by Staff in the Company's PGA case, Case No. AVU-G-05-2, Avista was ordered by the Washington Utilities and Transportation Commission to discontinue its use of the Natural Gas Benchmark Mechanism. 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's concern was that actions prompted by the Washington UTC may harm customers in Avista's Idaho service territory. Staff worked with the Company to complete a back cast analysis to determine if Idaho ratepayers would be harmed by the cessation of the mechanism. Based on the analysis assumptions, Staff believes it is reasonable to conclude that Idaho customers benefited slightly ($25,000) from the cessation of the mechanism.

In summary, Staff recommends that the requested decrease in the WACOG, and the 12-month amortization of deferred expenses be approved. Staff also recommends that the Company be directed to file further tariff decreases if the forecasted WACOG decreases materially or if the result of the pending FERC pipeline rate cases result in transportation expenses significantly less that what the Company has included in its proposed tariffs.

PUBLIC COMMENTS

The Commission received seven comments from customers of Avista. The comments shares a common theme in that they were concerned about any increases in natural gas rates because of newspaper articles and other media reports that market prices for natural gas are at two-year lows. All comments addressed the Company's initial request to increase rates. No comments specifically addressed the revised application requesting a reduction in rates.

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 file further tariff decreases if the forecasted WACOG decreases materially or if the result of the pending FERC pipeline rate cases result in transportation expenses significantly less that what the Company has included in its proposed tariffs?

3. 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?

Donovan E. Walker

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