

DECISION MEMORANDUM

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

FROM: SCOTT WOODBURY

DATE: OCTOBER 23, 2003

**RE: CASE NO. AVU-E-03-06 (Avista)
CONTINUATION OF POWER COST ADJUSTMENT (PCA) SURCHARGE**

On August 11, 2003, Avista Corporation dba Avista Utilities (Avista; Company) filed a Power Cost Adjustment (PCA) Schedule 66 Status Report with the Idaho Public Utilities Commission (Commission) and an Application requesting approved recovery of excess power costs deferred through June 30, 2003 and further continuation of a 19.4% (\$23.6 million) PCA surcharge currently scheduled to expire on October 11, 2003. Following a public hearing, the 19.4% surcharge was originally authorized by the Commission in Order No. 28876 dated October 11, 2001 in Case No. AVU-E-01-11. A 12-month continuation of the surcharge was authorized following a public workshop and comments in Order No. 29130 in Case No. AVU-E-02-6. In its Order continuing the surcharge, the Commission stated:

As we did last year, we find it reasonable to continue a close monitoring of the Company's PCA decisions and thus require the Company to file a PCA status report 60 days prior to the expiration of the PCA surcharge. As before, if the status report and our review of the actual PCA deferral balance supports continuation of the surcharge, we anticipate continuation of the surcharge for an additional term.

Order No. 29130, p. 16. The current status of the unrecovered Idaho PCA deferral balance as of June 30, 2003 is \$27,843,108.

Status Report – Application for Extension

The details of the deferred cost balance as reflected in the Company's PCA account are as follows:

Unrecovered Balance at June 30, 2002	\$45,600,228
Net Deferral Activity (July 2002 – June 2003)	6,789,503*
Amortizations Related to Surcharge Revenues (July 2002 – June 2003)	<u>(24,546,623)</u>
Unrecovered Balance at June 30, 2003	\$27,843,108

*Deferral Activity Detail

Net Increase in Power Supply Cost	\$23,383,629
Centralia Capital and O&M Credit	(2,817,996)
PGE Monitization Accelerated Amortization	(13,855,680)
Transfer Small Generation Capital Costs & Interest	(921,184)
Intervenor Funding Payment	1,138
Interest	<u>999,596</u>
Net Deferral Activity (July 2002 – June 2003)	\$ 6,789,503

During the review period, Avista reports that Idaho's share of power supply expenses exceeded the authorized level by \$25,924,662. The Company states that power supply expenses were higher than the authorized level due to several factors:

The largest factor was the sale of fixed price gas. Based on the average purchase and sale price, the fixed price gas purchases added approximately \$13.1 million to Idaho's share of power supply expense. Hydro-generation was approximately 12.9 aMW below the authorized level, which would account for approximately \$2.1 million of increased expense. Colstrip and Kettle Falls together generated approximately 8 aMW above the authorized. Rathdrum generated approximately 21 aMW below the authorized level due in part to the relatively low price of electricity compared to natural gas costs. The Company's other gas-fired generating plants, Northeast Turbine, Boulder Park, and the Kettle Falls Combustion Turbine generated 2 aMW during the period.

Other power supply expenses during the review period include a payment to terminate a long-term power purchase with Enron and the final lease payments of \$3.7 million (\$1.3 million Idaho share) related to the Kettle Falls Bi-Fuel generating units. The \$2.9 million Enron buy-out payment (\$960,000 Idaho share) occurred in October 2002, and was recorded as a power purchase expense. The Kettle Falls Bi-Fuel lease payments began in September 2001 and were included in the prior filing for the review period ending June 2002.

Another factor driving the deferrals is the age of the authorized case. The authorized case is based on loads, contracts and resources in place for the period July 1999 through June 2000. During that period, the Company had

several large off-system power sales that generated significant revenue. Almost all of the sales have ended and, as such, the revenue is reduced which is reflected in a reduction in Account 447, Sale for Resale, revenue of \$72 million on a system basis (\$24 million Idaho share). Purchased power expense has also decreased from the authorized level due in part to several long-term contracts ending. Purchased power expense, however, has decreased by only \$24 million on a system basis (\$8 million Idaho share). The Company plans to file a general rate case within the next year to reset the authorized level of power supply revenues and expenses.

Avista contends that continuation of the current surcharge is not only justified by the current level of unrecovered power cost deferrals, but is essential to the continued improvement in the financial health of the Company. Investor concerns surrounding cash flows, deferral balances, and the ability to recover costs in a timely manner have had an impact on the Company's financings. The Company's credit ratings were lowered by credit rating agencies to below investment grade in October 2001. Because of Avista's present credit ratings, debt is more expensive. Avista contends that it is imperative for both the Company and its customers that Avista continue to improve its financial condition so that investment grade credit ratings can be restored and so that longer-term debt can be refinanced on more reasonable terms.

Current projections indicated that with continuation of the 19.4% surcharge, the PCA deferral balance would reach zero in mid-2005. The actual point when the deferral balance reaches zero is dependent upon factors such as hydroelectric conditions, wholesale market prices, contract changes, etc., during the relevant period.

The Company requests that the Commission continue the PCA surcharge for an additional 12 months, beginning October 12, 2003 and continuing through October 11, 2004. The Company requests that its Application be processed pursuant to Modified Procedure, i.e., by written submission rather than by hearing.

On August 27, 2003, the Commission issued a Notice of the Company's PCA filing and scheduled dates in Lewiston (Sept. 08) and Coeur d'Alene (Sept. 09) for customers to discuss Avista's PCA/energy issues with Commission Staff. The Commission in its Notice made a preliminary determination as to the appropriateness of processing the Company's Application under Modified Procedure, i.e., by written submission rather than by hearing, and established a September 30, 2003, comment deadline. Reference IDAPA 31.01.01.201-204. Comments were filed by Commission Staff and a small number of the Company's customers. Staff recommends

a \$5,849,100 adjustment (net fuel expense for losses on natural gas combustion turbine (CT) fuel sold rather than burned) to the deferral balance, a continuation of the existing 19.4% surcharge and true-up in the Company's next PCA filing. Staff also proposes changes in the Company's Risk Management Policy.

On October 8, 2003, the Commission issued Order No. 29351 continuing the existing 19.4% Schedule 66 PCA surcharge for 60 days beyond the scheduled October 11, 2003, expiration or until such time as the Commission might issue an Order accepting, rejecting or modifying the Application in Case No. AVU-E-03-06. The extension was authorized to provide the Company an opportunity to file a written reply to Staff comments and to make a procedural recommendation regarding Staff's proposed adjustment.

STAFF COMMENTS

Staff performed a review and audit of the amounts that went into the Company's PCA deferral balance. Other than the net fuel expense item, Staff found the amounts recorded in the purchased power, thermal fuel, CT fuel and power sales accounts to be correct and recommends that they be included in the deferral balance as of June 30, 2003. Staff notes that the PGE credit is now fully amortized and will not be included in future PCA deferrals. In the current PCA filing, the PGE credit contributed \$13,855,680.

Interest Rate – PCA Deferral Balance

Staff notes that on May 16, 2003, Avista filed an Application in Case No. AVU-E-03-4 requesting that the interest rate for the Company's Power Cost Adjustment (PCA) deferral balance be set at a level higher than the rate for customer deposits. Staff and the Company agreed to a compromise solution adopted by the Commission in Order No. 29323, dated August 21, 2003. As reflected in the Commission's Order, a 200 basis point increase will be allowed in the interest applied to year end deferral balances during recovery based on the first in/first out (FIFO) method of accounting. The customer deposit interest rate would continue to apply to new deferral balances accrued during the calendar year. This interest rate methodology began January 1, 2003 and continues through June 30, 2005. The new interest methodology was not applied in the current PCA case filed by the Company. Staff proposes to include the results of the new methodology in this current PCA year's deferral balance and calculations. The result of Staff's adjustment increases the current year's deferral amount by \$256,727. This amount reflects the application of a 200 basis point adder to the current year's customer deposit rate of

2%, calculated on the existing balance throughout the months of January through June 2003; and the application of the customer deposit rate of 2% on the new deferrals, which continue to be calculated at simple interest.

As reflected in Staff's comments, the largest component of the Company's net deferral activity is the Net Increase in Power Supply Costs. The total net increase in power supply costs, \$23,383,629 is comprised of the following items:

1. Purchased Power	(\$7,083,766)
2. Thermal Fuel	(\$5,942,944)
3. CT Fuel	(\$948,195)
4. Sales for Resale	\$21,605,030
5. PGE Capacity Revenue True Up	(\$2,483,328)
6. Potlatch 25 aMW	\$4,260,572
7. Kettle Falls Bi-Fuel	\$1,102,506
8. Net Fuel Expense – Loss on Natural Gas Resold	\$11,817,650
9. Idaho Retail Revenue Adjustment	\$651,882
10. Wood Power Inc. Amortized Expense	\$352,788
11. Reverse Coyote Test Power Sales	\$51,434

Net Fuel Expense – Loss on Natural Gas Resold

Staff in its comments speaks to each component of power supply costs and specifically addresses the Net Fuel Expense portion. In the Company's last PCA case, AVU-E-02-6, Staff questioned the circumstances surrounding the acquisition and later sale of natural gas purchased by the Company to fuel the Coyote Springs II CCCT (combined cycle combustion turbine). The Company maintains that at the time natural gas was purchased, it was anticipated that Coyote Springs II would be operational and more economical to operate than making market energy purchases. As it turns out, Coyote Springs II was neither operational nor was it economical to use the gas at the Company's other facilities, given the price of the gas with previously purchased fixed-for-floating financial swaps. The effect is an abnormally high percentage of hedged gas to serve available resources at prices found to be uneconomical when compared to energy purchased from the market.

In Case No. AVU-E-02-6, Staff proposed that the Commission withhold judgment on \$578,748 in net fuel expense incurred in June of 2002 to serve Coyote Springs until a more complete evaluation was conducted regarding anticipated online dates, reasons for the operational delay and timing of the sale of gas acquired for the use of the plant. Pending further

investigation, the Commission in its Order removed the \$578,748. As part of its current PCA investigation, Staff has completed a comprehensive review of the gas purchase and sale transactions that generated losses on fuel resold and the excess net fuel costs requested for recovery in this case.

In March 2001, Avista entered into two contracts to secure gas and gas transportation for Coyote Springs to gas-fired power plant. Initially, Coyote Springs II was scheduled for testing in early 2002 and was expected to be commercially available in July of 2002. The two purchases for Coyote Springs II, with five corresponding financial swap transactions, are a primary concern to Staff. These purchases and financial swaps are shown in detail on Staff's Confidential Attachment C. The first gas supply contract (Deal A) was to be delivered November 1, 2001 through November 1, 2004. The fixed-for-floating financial swaps associated with this supply contract consist of two transactions. Since the delivery period did not begin for another six months, the price for October 2004 was locked three and one-half years into the future without additional documentation showing the analyses beyond October 2002. Additional analyses that should have been fully documented with the swap order, Staff contends, should include volatility analyses, price trend analyses and load requirements for the time period involved.

The second gas supply contract (Deal B) was for delivery to begin June 1, 2002 and continue through October 31, 2003. Avista entered into two fixed-for-floating financial swap contracts that were subsequently combined into one contract, for the entire delivery period. This transaction locked in the price of gas for a period of 17 months. Since the delivery period did not begin for another 13 months, the October 2003 price was locked two and one-half years into the future.

Gas from both contracts was sufficient to operate Coyote Springs II at its full 180 MW generating capacity through October 31, 2003. At the time the Deals were first entered into and at the time that the prices were locked, forward prices for electricity for an 18-month period were expected to be very high and the Company expected substantial purchased power cost savings and/or sales for resale revenues from the gas purchases. During June of 2001, day ahead electric market prices fell below \$100/MWh for the first time in a year and by September they were approximately \$25 per MWh, which is near the historic normal wholesale electric price. Given approximately \$6 gas, the drop in electric prices made it uneconomical to operate any of

Avista's gas-fired plants to make electricity. Instead Avista simply purchased its power needs on the electric market and sold the gas back into the gas market at a loss because gas prices also had declined.

In Avista's PCA filing last year, which covered the time period July 2001 through June 2002, losses on the sale of gas on Deal A amounted to approximately \$5.6 million and were approved for recovery. The loss on Deal B last year was approximately \$0.6 million (\$578,748). This amount was not recovered in the last PCA, but was deferred to the current PCA year for evaluation. In this year's PCA, which covers July 2002 through June 2003, Avista has included \$11.8 million in losses due to gas sales. Staff contends that it is likely there will be more losses on the sale of this gas through the end of the longest contract, which ends on November 1, 2003.

In last year's Order No. 29131, the Commission directed Staff to investigate and assess the reasonableness of Avista's Risk Management Policy (Staff Confidential Attachment J) and how it affects the Company's short-term resource acquisition decisions. The Company's Risk Policy addresses the purchase and sale of electricity as well as the purchase and sale of natural gas acquired to generate electricity. In general, this policy defines a mechanism that eliminates differences between loads and resources as the actual time need approaches. The Company's Risk Policy typically extends 18 months out, and tracks surpluses and deficiencies month by month down to projected needs in the coming month. As reflected in the Company's Risk Policy "this policy is intended to focus on short-term power and natural gas supply management, meaning the period of 18 months forward from any current date, as they relate to meeting near-term energy load obligations." Such a plan, Staff contends, is designed to reduce the financial risks that might otherwise be associated with large quantity, long-term sales or purchases made at a single point in time. In theory, Staff does not oppose entering into financial swaps or hedges to fix the price of gas. However, Staff is concerned about the length of the swaps that Avista entered into and the apparent lack of additional support 2½ and 3½ years in the future.

The gas deals that Avista entered into, Staff contends, were unusual. Avista Electric had no recent history of entering into purchase or sales arrangements that went outside of its normal 18-month position report planning period. Avista Gas Operations did not make purchases outside of a 12-month period that it uses to balance its gas need for its gas customers. Staff believes that the losses on the sale of gas from the two purchases resulted from substantial

risks that the Company took when it locked in the price for large quantities of gas for a period of time up to 3½ years after the date of the purchase. The risk substantially stems from the price paid, the fact that the price was established at only two points in time approximately 30 days apart, gas price levels and trends over time, the volume of gas purchased, the length of forward analysis and the duration of the purchases.

Risks could have been reduced, Staff contends, if smaller quantities of two, three or five thousand dth/day (decatherm/day) had been purchased over time instead of four financial swaps entered into over the period of a month totaling 40,000 dth/day for much of the entire three year period. Not only did the Company lock into the purchase side of the gas transaction at historically high gas prices, in large volumes at essentially one point in time, Staff contends that it failed to mitigate the risk by also securing some mechanism to lock into the power sale of the transaction for the excess energy. Staff contends that the Company's decisions were contrary to the previously cited principals of good risk management. The Company's Risk Policy allows for purchases that exceed 18 months in the future with proper authorization. Although the purchases were authorized, Staff contends that the documentation to support these substantially longer transactions is lacking. The Deal tickets provided some explanation as to why the long-term purchases were made at this point in time. The workpapers reiterate again and again that the purchases were entered into for the sole purpose of securing financing for the Coyote Springs II project. To the extent that the transactions were made for the purpose of financing Coyote Springs II, Staff contends that they were to meet Avista's cash flow requirements and were not necessarily associated with utility operations.

Whether the transactions were implemented for the purpose of obtaining project financing or not, the effect of undertaking financial swaps beyond the generally accepted period of 18 months as specified in the Company's Risk Policy was \$39,465,033 in losses on a system basis. This amount translates to \$11,785,048 on an Idaho jurisdictional basis after sharing. While Staff is critical of the Company with respect to its overall gas acquisition approach for Coyote Springs II, Staff limits its recommended adjustment to losses associated with Deal B during the period from June 2002 through June 2003. Gas losses incurred under Deal B, Staff contends, carry all the risk concerns previously identified with one additional concern. The purchase put the Company in a long position outside of established risk management limits. Staff recommends that losses on the sale of Deal B gas not be allowed to be deferred for PCA

recovery. The Deal B purchase, Staff contends, was speculative because the generation was not needed for load; it focused on future price changes and was not documented and shown to reduce “business risk.” Staff recommends disallowing the losses from Deal B for the months of June 2002 through June 2003, in the amount of \$5,849,100, with associated carrying charges of \$87,343, for a total adjustment of \$5,933,433.

Staff notes that the swaps on Deal B were entered with Avista Energy. The Company’s electric operations have claimed no dealings with Avista Energy so proper pricing mechanisms or safeguards have not been established. Absent an approved mechanism, the affiliate transactions with Avista Energy, Staff contends, should be priced at the lower cost or market. Therefore, the losses on Deal B should be repriced at market with the Company absorbing the loss rather than passing it to customers through the PCA. The loss from gas captured in the Idaho PCA deferral balance amounts to \$5,849,100 and reduced interest amounts to \$87,343, which reduces the deferral balance to \$21,906,665 as of the end of June 2003. Existing PCA rates are designed to recover approximately \$23.6 million in the period. If PCA rates were adjusted based on Staff’s calculations the rates would be reduced from 19.4% to 18.0%. However, Staff proposes that existing PCA rates be continued until the next PCA regardless of the final decision reached in this case. Rates can remain unchanged because in the future any differences between deferred costs and PCA revenues including accrued interest will be trued up.

Staff in its comments recounts the energy assistance programs available for low-income customers. Staff notes that Avista continues to offer rebate programs to customers who convert to energy efficient heating or water heating equipment. The Company also continued to promote Comfort Level Billing to help customers level out payments over a 12-month period.

Staff in its filed comments proposes that the Commission accept the Company’s PCA filing with the following recommendations and modifications:

1. The current 19.4% surcharge be continued until the next PCA filing regardless of the final decision reached by the Commission in this case. Staff also recommends any actual remaining deferral balance at June 30, 2004, be subject to review by the Commission prior to establishing a surcharge for any additional period of time, as provided for in Order No. 28876, Case No. AVU-E-01-11.

2. The net fuel expense for losses on natural gas CT fuel sold rather than burned under "Deal B" be denied for recovery in the PCA in the amount of \$5,849,100 and \$87,343 interest.

3. That the deferral balance be modified to include Staff's adjustments and corresponding adjustments to the carrying charges.

4. The Company be required to work with the Commission Staff and customers in developing an acceptable Risk Policy for the utilities division of Avista Corporation.

CUSTOMER COMMENTS

Staff notes that the Commission Staff held public workshops in both Lewiston and Coeur d'Alene regarding Avista's proposed continuation of its 19.4% surcharge. One customer attended the Lewiston workshop and no customers attended the Coeur d'Alene workshop. From the time Avista filed its PCA through September 29, 2003, the Commission received six written comments from customers. The deadline for filing comments was September 30, 2003. None of those who commented were in favor of the continuation of the surcharge.

COMPANY REPLY

On October 3, 2003, Avista filed Reply Comments. Avista does not agree with Staff's recommended disallowance of approximately \$5.9 million of deferred costs associated with certain natural gas costs for thermal generation. The transactions related to the costs at issue, the Company contends, were entered into in the spring of 2001, at a time when wholesale electric prices were at unprecedented highs, federal regulators were continuing to refuse to intervene, and Avista was facing the worst hydroelectric conditions in its history. The Company believes that a careful review of the information available at the time the transactions were entered into will show that the decisions were reasonable given the circumstances at the time.

Avista requests the opportunity to fully respond to Commission Staff's recommendations through evidentiary hearings. However, following discussions with Staff, Avista states that the Company and Staff agree that it would be administratively efficient for the Company to respond to Staff's recommendations in its upcoming general rate case, which Avista plans to file in the first quarter of 2004. If evidentiary hearings were to proceed in this case, the Company contends that they would likely overlap the general rate case proceedings.

Avista recommends continuation of the existing surcharge rates until the next PCA (through October 11, 2004). Avista commits to fully responding to the issues raised by Staff in this case, in its pre-file testimony in a general rate case, to be filed no later than March 31, 2004.

COMMISSION DECISION

Avista has requested approved recovery of excess power costs deferred through June 30, 2000 (\$27,843,108) and further continuation of a 19.4% (\$23.6 million) PCA surcharge.

Commission Staff in its filed comments recommends a disallowance of \$5,849,100 in net fuel expense (losses on sale of Coyote Springs II Deal B gas) together with \$87,343 in related carrying charge, for a total adjustment of \$5,933,433. Staff contends that the purchase was speculative and put the Company in a long position outside of established risk management limits.

Commission Staff in its comments also recommends increasing the current year's deferral amount by \$296,727 to reflect the effective January 1, 2003 approved change in the interest rate methodology. Reference Order No. 29323.

Commission Staff recommends that the Company be directed to work with Staff and customers in developing an acceptable Risk Policy for the utilities division of Avista Corporation.

Avista in its filed Reply requests the opportunity to fully respond to Staff's proposed net fuel adjustment (\$5,933,433). It is Avista's preference that the issue be deferred until the Company's next electric general rate case, to be filed no later than March 31, 2004. Staff supports the Company's request.

How does the Commission wish to handle Staff's proposed net fuel adjustment? Defer to the Company's next general rate case? If not, does the Commission wish to establish further scheduling in this case?

Does the Commission find it reasonable to approve Staff's interest adjustment to the June 30, 2003 PCA balance?

Does the Commission find it reasonable to direct Avista to work with Staff and customers to develop an acceptable Risk Management Policy?

Does the Commission find it reasonable to approve further continuation of the existing 19.4% (\$23.6 million) PCA surcharge?

Scott Woodbury

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