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December 4, 2007

Oregon Public Utility Commission
550 Capitol Street, NE
Salem, OR 97310-1380

Attention: Ms. Vikie Bailey-Googins

RE: UM 1286

Attached are the opening comments of Avista Utilities in Docket UM 1286 addressing the present PGA gas cost sharing mechanism, as well as incentive mechanisms in general. If you have any questions regarding this filing, please contact Brian Hirschkorn at 509-495-4723.

Sincerely,

Kelly Norwood

Kelly O. Norwood, Vice President
State and Federal Regulation

Enc.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have served Avista Corporation's Opening Comments in Docket UM 1286, by electronic mail and by mailing a copy, where paper service has not been waived, to the following:

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Dated at Spokane, Washington this 4th day of December 2007.

Patty Olsness
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UM 1286

AVISTA'S COMMENTS ADDRESSING GAS PROCUREMENT INCENTIVE MECHANISMS

As part of UM 1286, these comments address Avista's view of the present PGA gas cost sharing mechanism (mechanism), as well as natural gas incentive mechanisms in general.

Present PGA Gas Cost Sharing Mechanism

In 2005, the Commission Staff prepared a Natural Gas Procurement Study (Procurement Study) to examine the natural gas purchasing strategies of Oregon local distribution companies (LDCs) and regulatory treatment of gas procurement practices nationwide. Some notable observations included in the Procurement Study were that: 1) the current gas cost sharing mechanism within the PGA encourages Oregon LDCs to hedge a majority of their gas supply to avoid the potential financial risk of high gas prices, and 2) nationwide, there is very little performance-based ratemaking that focuses solely on natural gas purchasing strategies. These observations were also noted in Avista's comments on the Procurement Study, dated May 31, 2005.

Also noteworthy are the results of the UM 1286 workshops held throughout 2007. Eight half-day workshops were held and attended by representatives of the Staff, CUB, NWIGU and the three LDCs. Following discussions of "incentive mechanisms" in workshops 6 and 7, it became apparent that the parties could not reach a consensus on *any* of the issues and the final two workshops were canceled.

Avista's position regarding the present gas cost sharing mechanism is simple - it makes no sense when applied to the current natural gas market. The natural gas market has changed dramatically since this mechanism was implemented. Natural gas is now traded like other commodities in an open and robust market. The price of gas has increased several-fold over the past decade, and prices are extremely volatile. These higher prices and increased volatility have been created by the elimination of regulatory price controls on natural gas and a tight balance between supply and demand. As a result of this changed market, LDCs have no control over the price paid for natural gas at the time it is purchased, and cannot predict with any certainty what the price will be in the future. The price is set by the market, and the price can change from one minute to the next. Sharing or incentive mechanisms should only be employed where the LDC can affect the outcome through the application of its knowledge, experience and tools available.

As the price of natural gas has increased, so has the LDCs' financial risk under the sharing mechanism. As a relatively small LDC, even a small level of sharing under the present mechanism can have a major impact on the Company's earnings.

The present sharing mechanism establishes a projected monthly cost of gas in the LDC's PGA tariff that is compared against the actual monthly cost as the PGA year unfolds, with the difference being shared between customers and shareholders. The mechanism creates a condition where an LDC can reduce its exposure to unpredictable, volatile prices by fixing the price, through hedging, on a greater proportion of its natural gas requirements for the upcoming year. As noted in the Procurement Study, the mechanism has led the LDCs to hedge the majority of their gas requirements in order to

minimize the potential financial risk under the mechanism. In addition, the monthly price estimates included in the PGA for the unhedged volumes has a direct impact on the earnings of the Company, because the shared amount is based on the difference between these monthly price estimates and actual prices. Both of these factors have resulted in a seemingly endless debate over: 1) the appropriate level of hedging for the LDCs, and 2) the appropriate price estimates to be used for the unhedged portion of load requirements. These debates are time consuming and a distraction from more productive activities such as developing and managing a procurement strategy that is in the best interest of customers.

Additionally, the level of underground storage held by the LDC can affect the amount of financial risk it is exposed to under the present sharing mechanism. As the level of underground storage held by the three Oregon LDCs varies substantially by utility, this appears to be an issue under the present mechanism.

Alternative Incentive Mechanisms

During one of the workshops in this proceeding, Staff proposed a Gas Purchase Incentive Mechanism, or GPIM, as an alternative to the present sharing mechanism. As the Company understands it, Staff's proposed GPIM would apply to that portion of the LDC's gas purchases which have not been hedged. These volumes generally consist of: 1) First of the Month (FOM) gas - gas purchased at a uniform amount each day (10,000 dth) for an entire month based on estimated load requirements, and 2) daily purchases (or sales) to meet changing daily load requirements. The LDC can also use storage gas to displace these purchases. Under Staff's GPIM, actual gas purchase costs for these

volumes would be compared to a published index price. While this type of mechanism sounds simple in theory, in reality, it isn't. Even Staff admits that the details of the GPIM would have to be worked out.

An example of one of the issues associated with Staff's GPIM is that daily index prices are based on the average of all transactions at that basin/delivery point *after* the day is over. The Company buys (and sometimes sells) gas every day to meet its most current load forecast for the next day. When the Company enters the market to buy gas for that day, it tries to secure the best possible price at the time, but the market will move throughout the day and the price it pays will be above or below the published index. Alternatively, the Company can typically buy gas at index plus or minus some amount, i.e., index plus two cents per dekatherm. Again, the Company does not know what the index will be for that day, but by purchasing an index-based product, it can limit its financial risk under Staff's GPIM.

Avista's Proposal

The GPIM presented by Staff is a preferable incentive alternative as compared to the present gas cost sharing mechanism, however, the Company doesn't see the need for *any* gas procurement incentive mechanism. Nationwide, very few states have a gas procurement incentive mechanism. Again, the underlying premise of a natural gas incentive mechanism is that the LDC has a meaningful amount of control over the purchase price at the time the purchase is made, which it does not. Incentive mechanisms are complex and controversial, and it is difficult to identify and quantify all of the variables and parameters that should be incorporated within a mechanism, especially

when applied to the current natural gas market. A considerable amount of time must be spent designing a mechanism, as well as measuring and monitoring the results, time which could be spent on more productive activities.

The Company's preferred option would be a 100% pass through of *prudently* incurred gas costs with no incentive/sharing mechanism, which is the practice in the vast majority of other states. All LDC gas costs and transactions are subject to a prudence review. With the increase in natural gas prices/costs over the past decade, there are additional incentives for the LDCs to keep its purchased gas costs as low as possible that were not as prevalent when gas prices were $2.00/dekatherm. Higher gas costs result in higher rates with no additional margin to the Company. These higher gas rates negatively affect customers, and ultimately the Company. With higher gas rates, there has been increased attention from customers, as well as the media, who want to know that the Company is doing everything it can to keep its purchased gas costs as low as possible.

Additional comments to be submitted by the Parties in this Docket will address guidelines for the PGA mechanism and LDC procurement practices. The Company believes that the establishment of reasonable guidelines regarding gas procurement practices and documentation, including hedging levels and practices, eliminate any real or perceived need for an incentive mechanism. As part of the stipulation approved by the Commission in UM 1282, the investigation into Avista's hedging practices, specific guidelines were agreed to regarding Avista's gas procurement plan and hedging strategy. Over the past year, Avista has worked closely with the Staff and provided substantial documentation addressing the development and implementation of its procurement plan, as well as the level and timing of fixed-price hedges. Requirements related to each hedge

included a detailed market analysis at the time of hedge execution, competitive bidding information, and documentation of each transaction. The Company believes that the application of these and other reasonable gas procurement guidelines eliminate any need for an incentive or sharing mechanism.

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December 6, 2007

Public Utility Commission of Oregon
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RE: UM 1286

Avista Utilities, hereby submits for filing its comments addressing the PGA gas cost sharing mechanism, as well as incentive mechanisms in general. Avista filed its comments on December 4th, 2007 through the Commission's website service list with a hard copy sent via overnight mail. The filing did not include the PUC filing center, therefore, the Company apologizes for this oversight.

Please direct any questions regarding this filing to Brian Hirschkorn at (509) 495-4723.

Sincerely,

Linda Gervais

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c: Ms. Bonnie Tatom