

SCOTT WOODBURY
DEPUTY ATTORNEY GENERAL
IDAHO PUBLIC UTILITIES COMMISSION
PO BOX 83720
BOISE, IDAHO 83720-0074
(208) 334-0320
BAR NO. 1895

RECEIVED
FILED
2003 NOV -7 AM 10: 56
IDAHO PUBLIC
UTILITIES COMMISSION

Street Address for Express Mail:
472 W. WASHINGTON
BOISE, IDAHO 83702-5983

Attorney for the Commission Staff

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE JOINT PETITION)
OF AVISTA CORPORATION AND POTLATCH) CASE NO. AVU-E-03-7
CORPORATION FOR APPROVAL OF POWER)
PURCHASE AND SALE AGREEMENT.) COMMENTS OF THE
) COMMISSION STAFF
)

COMES NOW the Staff of the Idaho Public Utilities Commission, by and through its Attorney of record, Scott Woodbury, Deputy Attorney General, and in response to the October 23, 2003 Notice of Joint Petition, Notice of Modified Procedure, Notice of Comment/Protest Deadline and Notice of Reply Comment Deadline in Case No. AVU-E-03-7, submits the following comments.

BACKGROUND

Potlatch Corporation (Potlatch) owns and operates a wood pulp, paperboard, tissue and wood products manufacturing facility in Lewiston, Idaho. Potlatch has the capability at its Lewiston plant to produce energy in conjunction with its manufacturing processes. Prior to January 1, 1992, Potlatch utilized its generation to serve a substantial portion of its load requirements, with the balance of its load requirements served by Avista under electric tariff Schedule 25. From January 1, 1992 through December 31, 2001, Avista purchased 55 average megawatts (aMW) of Potlatch's generation and served essentially all of Potlatch's load

requirements under a special contract. The rates, terms and conditions for power purchases and sales under the special contract were negotiated between the parties and approved by the Commission in Order No. 23858 in Case No. WWP-E-91-5. As part of that case, Avista proposed and the Commission approved, special regulatory/accounting treatment of the contract, due in part to the size of the load and the unique nature of the contract.

Avista and Potlatch agreed, in a Joint Motion dated August 17, 2001, filed in Case No. AVU-E-01-5, that upon expiration of the special contract on December 31, 2001, Potlatch's load would be served under Schedule 25 rates. From January 1, 2002 through June 30, 2003, Potlatch used its approximate 60 aMW of generation to reduce its load requirements while purchasing the remainder (approximately 40 aMW) from Avista. Potlatch now desires to sell all of its generation to Avista and to purchase power from Avista to meet its full load requirements. After many months of negotiation, the parties have reached agreement on the future purchase and sale of power and seek Commission approval of the Power Purchase Agreement.

ANALYSIS

The Agreement

The Power Purchase and Sale Agreement (Agreement) submitted jointly by Avista and Potlatch is for a ten-year term, beginning July 1, 2003 and ending June 30, 2013. The Agreement is conditioned upon Commission approval of: (i) the Purchase and Sale Agreement as a settlement of all known existing disputes between the Parties, without precedential value and without prejudice to the Parties' positions on similar issues in the future; (ii) the direct assignment of all power purchase costs paid by Avista to Potlatch under the Purchase and Sale Agreement to Avista's Idaho operations; and (iii) the deferral and recovery of 100% of all power purchase costs paid by Avista to Potlatch under the Purchase and Sale Agreement to Avista's Idaho Power Cost Adjustment (PCA) or otherwise recovered by Avista through base rates.

Avista will be the sole purchaser of Potlatch's generation and such purchase is intended to satisfy Avista's obligations to purchase power from the Lewiston plant pursuant to the Public Utility Regulatory Policies Act of 1978 (PURPA). Avista will pay Potlatch \$42.92 per megawatt-hour (MWh) for up to a maximum Base Generation Amount of 543,120 MWhs generated by Potlatch during each July 1 through June 30 period ("Operating Year") of the Agreement. This amount is equivalent to 62 aMW and is referred to in the Agreement as the "Base Generation Amount." The Base Generation Amount will constitute the vast majority of

energy sales under the Agreement. Amounts generated by Potlatch in excess of the maximum Base Generation Amount each Operating Year (“Excess Generation Amounts”) will either be purchased by Avista at 85% of the applicable Dow Jones Mid-Columbia index price, with a price cap of \$55 per MWh, or used by Potlatch to reduce its load requirements from Avista. The purchase of Potlatch’s Excess Generation Amounts by Avista is limited to 43,800 MWhs (5 aMW) each Operating Year.

Additionally, Potlatch has the capacity to generate additional amounts (“Incremental Generation Amounts”) under certain circumstances. Potlatch could generate 10-20 megawatts of Incremental Generation for short periods of time when electric market prices are high, and perhaps as much as 50 additional megawatts at extreme market prices. Because both parties would benefit from Incremental Generation under these circumstances, the Agreement provides for the purchase by Avista of Incremental Generation Amounts, under the terms and conditions specified in the Agreement. Incremental Generation can be purchased by Avista, either on a prescheduled basis at 85% of market price from a unit contingent sale that Avista is able to make with a third party, or on a real-time basis at 80% of market price for the hour.

Avista will serve Potlatch’s net load requirements at Potlatch’s Lewiston Plant (approximately 40 MW) under its Extra Large General Service Schedule 25 rates, including all applicable rate adjustments, unless the Commission issues an order in the future authorizing different billing rates.

Proposed Price For Potlatch Generation

Potlatch’s generators have been certified by the Federal Energy Regulatory Commission (FERC) as PURPA “Qualifying Facilities.” As such, Avista has an obligation under PURPA to purchase power offered for sale at avoided cost rates established by the Commission. The established method for determining avoided cost rates for projects larger than ten megawatts is an Integrated Resources Plan (IRP)-based methodology. The avoided cost methodology is described in Order No. 26576 and its accompanying Settlement Stipulation.

One of the reasons for adopting an IRP-based avoided cost methodology was that larger projects were thought likely to have project-specific characteristics that would make their generation more or less valuable than the published avoided cost rates. In addition, large projects were big enough that their generation could conceivably have a significant impact on a utility’s need for new resources. Large projects could perhaps eliminate the need to add new

resources as identified in the utility's IRP, or at least possibly defer the need for adding a new resource. In order to recognize and fairly value the different individual characteristics of large projects, a methodology was formulated based on utilities' IRPs and computer models that compute power supply costs.

The rate computed for Potlatch is the first under the methodology. Staff believes the IRP-based methodology is a reasonable method for calculating avoided cost rates for large projects. In fact, Staff believes that the methodology may be even more appropriate today given that the modeling tools available to the utilities have improved.

Determination of the Contract Rate for Base Generation

Avista performed an analysis using the AURORA computer model to determine the value of Potlatch's generation. In its analysis, Avista modeled six different scenarios involving Potlatch and Coyote Springs II. Also using AURORA, Staff reviewed the analysis and computations done by Avista, verified the input data and the assumptions and confirmed the rate offered to Potlatch. Staff believes Avista has correctly followed the methodology for computing an avoided cost rate as described in Order No. 26576.

Coincidentally, Avista had just completed calculating its avoided cost as part of its 2002 IRP using AURORA and a nearly identical methodology to that prescribed by the Commission for computing avoided costs. The rate for the Base Generation Amounts of \$42.92 per MWh is a ten-year levelized avoided cost rate from Avista's 2002 IRP, essentially verified by the independently modeled computer runs made to calculate the value of Potlatch generation. The rate represents an estimate of future market prices that fully reflects the fixed costs of new generation.

Another method used by Staff to verify the value established for Potlatch generation was to compare the purchase price to published avoided cost rates for projects 10 MW and smaller. The non-fueled published avoided cost rate for a ten-year contract length and a 2003 online date is \$44.43 per MWh. These rates are based on the cost of generating energy using a gas-fired combined cycle combustion turbine (CCCT). As previously mentioned, the small difference in these two prices can be justified based on the different operating characteristics of Potlatch generation and a CCCT. The ten-year levelized price approved by the Commission and paid by Avista for Potlatch generation in the 1992 special contract was \$41.50 per MWh.

Staff believes the rate for Base Generation in the Agreement fairly represents the value of Potlatch's generation and is satisfied that the method used to derive the rate conforms closely enough to the methodology as prescribed in Order No. 26576 and its Settlement Stipulation.

Contract Rate for Excess and Incremental Generation Amounts

Under the Agreement, Excess Generation (i.e., amounts generated by Potlatch in excess of the Base Generation Amount) will either be purchased by Avista at 85% of the applicable Mid-Columbia (Mid-C) index price, with a price cap of \$55 per MWh, or used by Potlatch to reduce its load requirements from Avista. The purchase of Potlatch's Excess Generation Amounts by Avista is limited to 5 aMW each Operating Year.

Staff believes that a purchase price equal to 85% of the Mid-C index price is reasonable. In addition, the rate is consistent with comparable rates paid by other utilities. The price is the same as the price paid by Idaho Power for the equivalent of excess energy in some of its PURPA contracts and is also equal to Idaho Power's non-firm energy rate under its electric Schedule 86.

Staff also believes it is reasonable to cap the price paid for Excess Generation Amounts at \$55 per MWh. Mid-C index prices have soared on occasion in the past few years to levels many times normal, and price excursions even beyond the \$55 range have not been unusual. A price cap of \$55 will insure that Avista is not forced to pay excessive amounts, yet it will provide the Company an opportunity to purchase small amounts of energy at below market prices when supplies are limited.

Incremental Generation is energy produced by Potlatch that exceeds the Base Generation Amounts and the Excess Generation Amounts. The rates for Incremental Generation are either: a) for prescheduled generation, 85% of market price from a unit contingent sale that Avista is able to make with a third party, or b) on a real-time basis at 80% of market price for the hour. Staff believes that these rates are reasonable for Incremental Generation. As the Agreement is structured, both parties will benefit from the sale and purchase of Incremental Generation. Potlatch will be able to receive additional benefit from its extra generation during periods when market prices are high, while Avista will be able to benefit by purchasing from Potlatch at below market prices.

Service Pricing

The 1992 special contract price for Avista to serve Potlatch was essentially based on electric prices in the market place. The price of all but the 25 MW of interruptible load also included floor and ceiling prices designed to stabilize both revenues collected by Avista and costs incurred by Potlatch within a specified range. The average cost for non-interruptible service under the old contract was approximately \$42.50 per MWh in 2001.

Under the proposed contract, Avista will provide service to Potlatch under the terms and conditions of the Company's existing Extra Large General Service Schedule 25. This schedule requires Potlatch to pay an average base rate of \$31.71 per MWh, generating approximately \$27.7 million per year in base revenues. Potlatch will also be subject to the Tax Adjustment Schedule 58, the Temporary Rate Adjustment Schedule 65, the Power Cost Adjustment Schedule 66 and the Energy Efficiency Rider Adjustment Schedule 91. When the rate from non-tax Schedules 65, 66 and 91 are added to the base rate, the 2003 price paid by Potlatch for service averages \$38.65 per MWh. Although Potlatch's 100 MW of load exceeds the Schedule 25 limit of approximately 25 MW, Schedule 25A, which is part of Schedule 25 states:

Customers whose demand from all such meters exceeds 25,000 KVA (25 MW) may be served under special contract wherein the rates, terms, and conditions of service are specified and approved by the I.P.U.C. If customer requires service during either the contract negotiation or resolution period, service will be supplied under this rate schedule...

Potlatch is by far Avista's largest single customer and electric Schedule 25 has the largest load requirement currently approved by the Commission for Avista. Absent an analysis to specifically identify Potlatch service costs, Schedule 25 is the most appropriate proxy to reflect Potlatch embedded cost of service. Given that current Schedule 25 rates are based on the embedded cost to serve a group of industrial customers that are much smaller than Potlatch, it is likely that specific embedded costs to serve Potlatch could be lower than those used to set Schedule 25 rates. While Staff believes the rates proposed in the Agreement adequately cover Potlatch embedded cost of service, the Agreement allows any party to argue, in the context of a future proceeding, that the cost to serve Potlatch justifies rates that are either higher or lower than those found in Schedule 25. Consequently, the Commission has the explicit ability to modify service prices during the term of the Agreement.

Avista maintains that to the extent the Company's overall costs rise, e.g., through general rates, the cost to serve Potlatch will increase relative to the cost of purchasing Potlatch generation. However, Staff also believes there is a risk that service rates applied to Potlatch could decline in the next general rate case to the extent the cost to serve Potlatch is found to be below the cost to serve all other Schedule 25 customers. Nevertheless, Staff believes the rates proposed to both purchase power from Potlatch and sell power to Potlatch were appropriately derived and reasonably supported.

Jurisdictional Allocation

In order to understand the jurisdictional allocation rationale proposed by the Company for the new Agreement, one must understand the history of service to Potlatch and the traditional methodology used to jurisdictionally allocate Avista costs and revenues. The methodology approved by the Commission to historically allocate cost between the various jurisdictions includes an allocation of all generation costs based on the jurisdictional weighting of demand and energy. Revenue, on the other hand, has always been directly assigned to the jurisdiction where the customer resides.

Prior to 1992, Avista paid nothing for Potlatch generation and received revenue from Potlatch based upon the net load served after Potlatch used its generation to partially offset its load. Revenues from this service arrangement remained in the Idaho jurisdiction and generation costs associated with serving the net load were allocated among the Idaho and Washington jurisdictions. Effectively, Idaho retained that portion of average system generation costs based upon Potlatch net energy and demand. Potlatch net revenue was retained in Idaho to cover those costs.

Under the 1992 special contract approved by the Commission, Avista purchased all Potlatch generation at a pre-established price and received revenue from Potlatch based on its total load. The effect of this service arrangement under traditional jurisdictional allocation methodology was simply an increase in generation costs allocated to other jurisdictions. This is due to a traditional allocation methodology that adds generation cost to the system on the margin but allocates increased system generation costs to Idaho on the average (i.e. treating Potlatch load that was previously self generated as having an entitlement to embedded cost resources). Allocation of all revenues on a situs basis compounded the problem. To counteract this effect, the 1992 contract approval included allocation of 60 MW of Potlatch revenues as well as

purchase power costs of 60 MW of Potlatch generation on a jurisdictional basis. This adjustment was a compromise that balanced costs allocated to the various jurisdictions with offsetting revenues and worked fairly well because revenues from 60 MW of Potlatch load were fairly close to the costs of purchasing 60 MW of Potlatch generation.

Under the new Agreement, the cost of purchasing 60 megawatts of Potlatch generation is significantly higher than the revenue generated from serving 60 megawatts of Potlatch load. Consequently, the Company is proposing yet another jurisdictional allocation. Avista proposes to directly assign all revenues and costs associated with the 60 megawatts of Potlatch load and generation to Idaho. This allocation methodology places the net cost of buying 60 megawatts from Potlatch and selling 60 megawatts back to Potlatch on the Idaho jurisdiction. All other jurisdictions are held harmless by this transaction.

Although no other generation costs are jurisdictionally allocated in this fashion, the Company believes it is appropriate in this case because the Agreement provides the opportunity for additional benefits to Idaho customers and Idaho is the primary beneficiary of “secondary” benefits. In addition, the Company does not believe the Washington Utilities and Transportation Commission (WUTC) would accept the ratemaking consequences of the Agreement using traditional allocation methodology. Nor does the Company believe that Avista shareholders should bear the additional costs deemed unacceptable by the WUTC. The Company believes the Agreement is “an Idaho solution to an Idaho problem.”

Revenue Impact

Revenues and expenses associated with the Avista/Potlatch service arrangement have changed on an interim basis since the 1992 special contract expired at the end of 2001. However, for the purposes of this case, Staff evaluated Idaho revenue impact by comparing net revenues/costs included in base rates under the 1992 contract to revenues/costs that will be included in rates under the new Agreement. Until the new jurisdictional allocation methodology and revenues/costs of the new Agreement are included in base rates as part of a general rate case, the Company proposes to account for the changes through the PCA. The comparison also reflects that Potlatch is subject to the PCA under the new Agreement but was not subject to the PCA under the old contract.

The simplest way to evaluate the impact of the new Agreement is to compare the net cost of the two contracts on a system basis. The old contract had annual system expenses of \$28.8

million and annual system revenues of \$26.2 million for a net annual cost of \$2.6 million. The new Agreement has annual system expenses of \$31.25 million and annual revenues of \$27.7 million for a net system cost of \$3.6 million. Therefore, the new Agreement increases annual net costs by approximately \$1 million on a system basis.

However, the change proposed in the jurisdictional allocation shifts most of the costs to the Idaho jurisdiction. Under the jurisdictional allocation methodology approved with the old contract, the net cost allocated annually to Idaho is actually a benefit of \$296,000. Under the allocation methodology proposed with the new Agreement, Idaho costs increase by \$4.1 million from a \$296,000 allocated net benefit to a \$3.8 million directly assigned net cost. The Company proposes to pass this annual expense increase through the PCA until costs are included in base rates. A \$4.1 million increase in base rates represents a 2.3% overall increase in Idaho revenue requirement on a permanent basis. On the other hand, Potlatch will contribute approximately \$5.3 million during the current year as a Schedule 25 customer subject to the PCA. Therefore, the net effect of the new Agreement during the 2003 PCA period is a \$1.2 million reduction in costs borne by other Idaho customers.

As previously mentioned, there is a possibility that the net cost of the Agreement could increase in the future if rates applied to serve Potlatch are reduced. Moreover, there will be no offsetting revenue through the PCA from Potlatch under normal water and power supply conditions to offset the effect of higher base rates. In fact, during high water conditions, Potlatch will receive some of the PCA credit that would otherwise go to other Idaho customers. However, because the rate paid to Potlatch for generation is fixed, it is likely that the cost differential between the cost to serve Potlatch and the cost to buy its generation will ultimately decline.

CONCLUSIONS

After review of the Joint Petition presented by Avista and Potlatch along with supporting testimony, Staff concludes that the proposed Agreement may be the only practical approach to resolving the Potlatch service arrangement dispute. This conclusion was not reached without considerable discussion and evaluation to address concerns regarding jurisdictional allocation of service arrangement costs and revenues as proposed by Avista.

While Avista and Potlatch have agreed to the terms in the Agreement after lengthy, often contentious negotiations, continued agreement is subject to approval by the Commission of

conditions established by Avista. The Agreement conditions include adoption of a special jurisdictional allocation of contract costs and 100% recovery through the PCA or base rates of power purchase costs incurred by Avista as a result of the Agreement.

Staff has spent considerable time and effort evaluating the proposed prices to purchase Potlatch generation and serve Potlatch load and conclude they are reasonable. The proposed price paid by Avista for Potlatch generation of \$42.35 per MWh is slightly less than the Company's published avoided cost rate over the ten-year period of \$44.25 and corresponds to the avoided cost rate calculated in the Company's latest IRP. The annual cost for Avista to purchase Potlatch generation is only \$420,000 more than it was under the old contract and will remain in effect over the entire life of the new Agreement. Staff also accepts Avista's proposal to allow 100% recovery of the purchase power costs through the PCA. This treatment is consistent with that provided to Idaho Power Company for mandated purchases from PURPA projects and will soon be subject to 100% recovery anyway as a result of the upcoming general rate case.

The proposed price charged by Avista for electrical service to Potlatch is the existing Schedule 25 rate for large industrial customers. By agreeing to apply Schedule 25 rates to Potlatch's entire 100 MW load, Staff concedes a Potlatch entitlement to embedded cost rates. While Avista has also agreed to serve all Potlatch load under Schedule 25 rates, it does not agree to include the net cost to serve 60 MW of that load in its traditional jurisdictional allocation methodology.

The financial effect of approving the rates with the proposed allocation is a permanent 2.3% base rate increase for Avista's other Idaho customers. Potlatch will be subject to the PCA under the proposed Agreement so Idaho customers will experience relatively lower PCA rates during surcharge periods but will also share credits with Potlatch during refund periods.

Staff understands Avista's desire to specify allocation conditions in order to agree to the rates described above. The fact is, the net cost of the Agreement increases under the proposed rates because expenses exceed revenues. For Avista to be made whole under the jurisdictional allocation previously approved for the old contract, the Company must collect a large portion of the excess costs from Washington customers.

While Staff has no desire to see increased rates for Avista's Idaho customers, it sees no other reasonable alternative to supporting Agreement approval with Avista's conditions. From a practical standpoint, someone must pay the difference between serving Potlatch at embedded cost and purchasing Potlatch generation at marginal cost. Staff has already agreed that the rates

established under the Agreement appear to be reasonable. Staff also recognizes that Potlatch is an Idaho customer providing employment and taxes in Idaho. If rates are appropriately established and benefits accrue primarily to Idaho, then it seems reasonable to recover costs from Idaho customers.

Beyond Avista's promised withdrawal from the Agreement, the consequences of denying the Company's request are difficult to predict. Absent a mutually agreeable purchase/sales contract, Potlatch would need to reevaluate its options with regard to generating into its own load or selling its generation off system. Avista would need to reevaluate the cost and its ability to serve Potlatch load if the size of that load depends upon availability of Potlatch generation. Disagreement would continue and costs ultimately borne by Idaho ratepayers could be even higher.

Absent an agreement, Potlatch could continue to generate into its own load indefinitely. As long as Potlatch continued to do so, it would in effect receive the equivalent of its Schedule 25 retail rate for its generation. Alternatively, Potlatch could choose to simply sell its generation on the market or to some utility other than Avista. However, if Potlatch chose to sell outside of Avista's system, then Avista would have to serve Potlatch's full load of 100 MW by acquiring other resources rather than relying on Potlatch generation. Potlatch would need to commit to a steady load for a fixed time period in order to qualify for Schedule 25 rates. Alternately selling off system by Potlatch and then generating into its own load could cost Potlatch, Avista, and ultimately its ratepayers, more in the long run.

Finally, the Commission could direct Avista to serve Potlatch under the proposed Agreement, deny the proposed cost allocation methodology and require Avista to seek 67% of the net contract cost differential from the Washington jurisdiction. It is unlikely that Idaho Commission Staff would support such a recovery if the roles were reversed. Staff does not recommend such a decision in this case. Given that the benefits of the Agreement primarily accrue to Idaho, that the proposed rates are properly derived and supported using the Idaho avoided cost methodology, that Potlatch is an Idaho customer that has historically utilized its generation to serve its own load and the fact that the incremental 60 MW load makes up such a large portion of Avista's overall load, Staff does not oppose the proposed Agreement rates nor the proposed cost recovery conditions.

RECOMMENDATIONS

Staff recommends that the Commission approve the submitted Power Purchase and Sale Agreement between Avista and Potlatch. Staff also recommends that all power purchase costs paid by Avista to Potlatch under the Agreement and all revenues received by Avista for serving the 60 MW of incremental load be directly assigned to Avista's Idaho jurisdiction. Finally, Staff recommends the Commission allow deferral and recovery of 100% of all power purchase costs paid by Avista to Potlatch under the Agreement to Avista's Idaho Power Cost Adjustment ("PCA") or otherwise recovered by Avista through base retail rates.

Respectively submitted this *7th* day of November 2003.



Scott Woodbury
Deputy Attorney General

Technical Staff: Rick Sterling
Randy Lobb

i:umisc:comments/avue03.7swrps

CERTIFICATE OF SERVICE

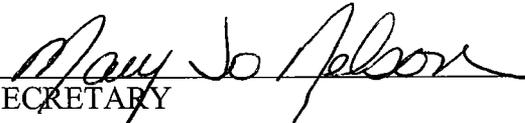
I HEREBY CERTIFY THAT I HAVE THIS 7TH DAY OF NOVEMBER 2003, SERVED THE FOREGOING **COMMENTS OF THE COMMISSION STAFF**, IN CASE NO. AVU-E-03-7, BY MAILING A COPY THEREOF, POSTAGE PREPAID, TO THE FOLLOWING:

DAVID J. MEYER
SR VP AND GENERAL COUNSEL
AVISTA CORPORATION
PO BOX 3727
SPOKANE WA 99220-3727

R. BLAIR STRONG
PAINE, HAMBLLEN, COFFIN, BROOKE &
MILLER LLP
717 W. SPRAGUE AVE, SUITE 1200
SPOKANE, WA 99201

PAMELA MULL
ASSOCIATE GENERAL COUNSEL
POTLATCH CORPORATION
601 W RIVERSIDE AVE SUITE 1100
SPOKANE WA 99201

CONLEY WARD
GIVENS PURSLEY
277 N 6TH STREET SUITE 200
PO BOX 2720
BOISE ID 83701-2720


SECRETARY