

DECISION MEMORANDUM

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

FROM: SCOTT WOODBURY

DATE: DECEMBER 11, 2003

**SUBJECT: CASE NO. AVU-E-03-7 (Avista)
POWER PURCHASE AND SALE AGREEMENT (POTLATCH
CORPORATION)**

On August 25, 2003, Avista Corporation dba Avista Utilities (Avista) and Potlatch Corporation (Potlatch) filed a Joint Petition with the Idaho Public Utilities Commission (Commission) requesting an Order approving a submitted Power Purchase and Sale Agreement (Agreement) between Avista and Potlatch dated July 22, 2003. Potlatch operates a wood pulp, paperboard, tissue and wood product manufacturing facility in Lewiston, Idaho. Potlatch owns and operates four electric generators at the Lewiston plant that are capable of generating approximately 130 megawatts (MWs) of energy. The Potlatch electric generators are qualifying facilities (QFs) pursuant to the Public Utilities Regulatory Policies Act of 1978 (PURPA). Direct testimony of Avista supporting the Purchase and Sale Agreement was filed with the Commission on September 26, 2003. Also filed with the Commission on October 10, 2003 is a related Interconnection Agreement dated September 22, 2003.

Agreement

The submitted Power Purchase and Sale Agreement is for a ten-year term beginning July 1, 2003 and ending June 30, 2013. The Agreement is conditioned upon approval by the Commission of 1) a direct assignment to Avista's Idaho operations of all power purchase costs paid by Avista to Potlatch under the Purchase and Sale Agreement and 2) 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) mechanism (Schedule 66) or otherwise recovered by Avista through base rates.

As recited in the Joint Petition of the parties, Avista will be the sole purchaser of Potlatch's generation and said purchase is intended to satisfy Avista's obligations under PURPA to purchase power from the qualifying facilities at the Lewiston plant. Avista will pay Potlatch \$42.92 per MWh up to a maximum base generation amount of 543,120 MWh (544,608 during a leap year) generated by Potlatch during each July 1 through June 30 period (Operating Year) of the Agreement. This amount is equivalent to 62 average MW and is referred to in the Agreement as the "Base Generation Amount." Amounts generated by Potlatch in excess of the maximum Base Generation Amount each Operating Year ("Excess Generation Amount") will either be purchased by Avista at 85% of the applicable Mid-Columbia Index Price, with a price cap of \$55 per MWh, or used by Potlatch to reduce its load requirement from Avista. The purchase of Potlatch's Excess Generation Amount by Avista is limited to 43,800 MWh (5 average MW) each Operating Year.

Additionally, it is noted that Potlatch has the capacity to generate additional amounts ("Incremental Generation Amounts") under certain circumstances. The Purchase and Sale Agreement provides for the purchase by Avista of Incremental Generation Amounts, under the terms and conditions specified in the Agreement.

As reflected in the Agreement, Avista will serve Potlatch's load requirement at Lewiston's plant 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.

Avista and Potlatch request that the Commission issue an Order approving the Purchase and Sale Agreement as a settlement of all known existing disputes between the parties, including without limitation, Case No. AVU-E-01-5 (In the matter of the Petition of Potlatch Corporation for an Order determining the terms and conditions of Potlatch's purchase of electricity from Avista Utilities) and Case No. AVU-E-02-8 (a Potlatch complaint alleging that Avista was refusing to purchase the cogeneration of Potlatch's PURPA qualifying facilities at its Lewiston plant).

On October 23, 2003, the Commission issued Notices of Joint Petition and Modified Procedure in Case No. AVU-E-03-7. The deadline for filing written comments was November 14, 2003. The reply deadline was November 28, 2003. Commission Staff was the only party to file comments. No reply comments were filed.

Staff Comments

Staff recommends that the Commission (1) approve the submitted Power Purchase and Sale Agreement between Avista and Potlatch; (2) approve Avista's proposal to directly assign to Avista's Idaho jurisdiction all power purchase costs paid by Avista to Potlatch under the Agreement and all revenues received by Avista for serving the 60 megawatts of Potlatch and incremental load; and (3) authorize deferral and recovery in the Company's Idaho PCA of 100% of all power purchase costs paid by Avista to Potlatch under the Agreement or recovery through base retail rates. Staff comments can be summarized as follows:

Proposed Price for Potlatch Generation

Staff notes that 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 10 megawatts is an Integrated Resource Plan (IRP)-based methodology. The avoided cost methodology is described in Order No. 26576 and its accompanying Settlement Stipulation. The rate computed for Potlatch is the first under the IRP-based methodology.

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. 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. The rate for Base Generation Amounts of \$42.92 per MWh is a 10-year levelized avoided cost rate from Avista's 2002 IRP. 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 10-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). The small difference in these two prices, Staff contends, can be justified based on the different operating characteristics of Potlatch generation and a CCCT. The 10-year levelized price approved by the Commission and paid by Avista for Potlatch generation in the 1992 special contract was \$41.50 per MWh.

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, Staff contends that 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. 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

Staff notes that 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. The average cost for non-interruptible service under the old contract was approximately \$42.50 per MWh in 2001.

Under the proposed Agreement, 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 IPUC. If customer requires service during either the contract negotiation or resolution period, service will be supplied under this rate schedule. . . .

Potlatch, Staff notes, 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, Staff contends that 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, Staff speculates that it is likely that specific embedded costs to serve Potlatch could be lower than those used to set Schedule 25 rates. The Agreement allows either party in the context of a future proceeding to argue that the cost to serve Potlatch justifies rates that are either higher or lower than those found in Schedule 25. Staff believes the rates proposed to both purchase power from Potlatch and sell power to Potlatch were appropriately derived and reasonably supported.

Jurisdictional Allocation

The methodology approved by the Commission to historically allocate cost between Avista's 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.

Under the 1992 special contract, 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 megawatts 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 megawatts of Potlatch load were fairly close to the costs of purchasing 60 megawatts 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 method. 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. Avista states also that it does not believe the Washington Utilities and Transportation Commission (WUTC) would accept the ratemaking consequences of the Agreement using traditional allocation methodology. Nor the Company states does it 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

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, Staff notes that 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.

Staff notes that 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, Staff contends that it is likely that the cost differential between the cost to serve Potlatch and the cost to buy its generation will ultimately decline.

Conclusions

Staff has spent considerable time and effort evaluating the proposed prices to purchase Potlatch generation and serve Potlatch load in concludes that 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 10-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.

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.

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. From a practical standpoint, someone must pay the difference between serving Potlatch at embedded cost and purchasing Potlatch generation at marginal cost. Staff recognizes that Potlatch is an Idaho customer providing employment and taxes in Idaho. If rates are appropriately established and benefits accrue primarily to Idaho, Staff believes it is reasonable to recover costs from Idaho customers. Staff does not oppose the proposed Agreement rates nor the proposed cost recovery conditions.

Commission Decision

Avista and Potlatch have submitted a Power Purchase and Sale Agreement for Commission approval. Staff supports the Agreement and proposed method of cost recovery. Does the Commission continue to find it reasonable to process this case pursuant to Modified Procedure? Does the Commission find the contract terms, pricing, jurisdictional allocation and proposed recovery method to be reasonable and acceptable?

Scott D. Woodbury

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