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IDAHO PUBLIC
UTILITIES COMMISSION

Attorneys for Potlatch Corporation
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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION
OF AVISTA CORPORATION FOR THE
AUTHORITY TO INCREASE ITS RATES
AND CHARGES FOR ELECTRIC AND
NATURAL GAS SERVICE TO ELECTRIC
AND NATURAL GAS CUSTOMERS IN THE
STATE OF IDAHO.

Case Nos. AVU-E-04-1
AVU-G-04-1

PREHEARING MEMORANDUM

- I. AVISTA HAS NOT MET ITS BURDEN OF PROVING ITS PURCHASE OF COYOTE SPRINGS 2 FROM AN AFFILIATE “AT COST” WAS REASONABLE AND PRUDENT. THEREFORE, SUCH COST SHOULD NOT BE WHOLLY INCLUDED IN RATE BASE.**

A regulated entity has the right to collect a return only on “necessary and prudent investments.” *Utah Power & Light Co. v. IPUC*, 105 Idaho 822, 826, 673 P.2d 422, 426 (1983) (“*Utah Power & Light IP*”) (citing *Citizens Util. Co. v. IPUC*, 99 Idaho 164, 171, 579 P.2d 110, 117 (1978)). Avista Corporation’s (“Avista”) at-cost purchase of half of Coyote Springs 2 (“CS2”) from its subsidiary, Avista Power, was not a prudent investment given the exorbitant

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underlying costs that greatly exceeded the plant's fair value.¹ Avista's purchase of CS2 is especially suspect because the seller was an Avista affiliate. Thus, Avista bears the burden of proving the purchase was reasonable and prudent and the Commission must carefully scrutinize the purchase to prevent potential self-dealing at ratepayers' expense. *Boise Water Corporation v. IPUC*, 97 Idaho 832, 836, 555 P.2d 163 (1976) ("*Boise Water I*").

A. Affiliate Transactions Are Subject To Heightened Commission Scrutiny, With The Burden Of Proof On The Utility.

Costs paid by utilities to their affiliates are subject to heightened Commission scrutiny, and the utility bears the burden of proving such costs are reasonable. The seminal Idaho case for this legal standard is *Boise Water I*. There, the Idaho Supreme Court reviewed a utility's request to recover from ratepayers certain costs paid to its parent corporation. The Court stated that the company had the burden of producing evidence to show that costs paid to an affiliate were reasonable. *Id.* at 836. The Court then cited authority from other jurisdictions for the proposition that costs paid to an affiliate must be subjected to greater scrutiny to ensure such costs are reasonable and are not improperly allocated to ratepayers. *Id.* at 837. Using these legal standards, the Court found the company did not meet its burden of reasonableness simply by demonstrating the incurrence of the expense. *Id.*

In *Washington Water Power Co. v. IPUC*, 105 Idaho 276, 668 P.2d 1007 (1983) ("*WWP I*"), the Idaho Supreme Court reiterated the need for heightened scrutiny of affiliate transactions. In *WWP II*, the Court held that Washington Water Power ("*WWP*") did not carry its burden of proving the cost of its coal purchase from an affiliate was reasonable. The Court explained that *WWP*'s evidence of arms length bargaining was insufficient by itself to show reasonableness

¹ In this Trial Memorandum, "Avista" refers to Avista Corporation, the regulated public utility and parent company to Avista Power, an unregulated subsidiary. For further explanation of these entities, see *Direct Testimony of Dennis E. Peseau on Behalf of Potlatch Corporation* (June 21, 2004) ("*Peseau Direct Testimony*"), pp. 5-6.

where the deal involved an affiliate. *Id.* at 279, 668 P.2d at 1010. “In such a transaction there arises the potential for two separate threats to a reasonable price: collusion and inhibited competition.” *Id.*

The Federal Energy Regulatory Commission (“FERC”) also subjects affiliate transactions to heightened scrutiny in order to protect ratepayers against the potential self-dealing of a buyer choosing the more expensive product from its affiliate. *Southern California Edison Co.*, 106 FERC 61,183 (Feb. 25, 2004); *Boston Edison Co. Re: Edgar Electric Co.*, 55 FERC 61,382, 61,190-91 (June 7, 1991). Specifically, FERC seeks, through its heightened scrutiny, to ensure that the buyer in an affiliated transaction “has chosen the lowest cost supplier from among the options presented, taking into account both price and non-price terms (i.e., that it has not preferred its affiliate without justification).” *Edgar*, 55 FERC at 61,190-91.

In this case, Avista paid an affiliate the “at cost” price for the CS2 plant even though that price exceeded the fair market value of the plant. The burden of proof is on Avista to prove that the CS2 purchase price was reasonable, and the Commission must carefully scrutinize the deal to make sure Avista has not improperly colluded with or benefited its affiliate. Avista cannot meet this burden in this case.

B. Avista’s Purchase Of CS2 At Avista Power’s Cost Was Not Necessary And Economically Desirable.

In *Utah Power & Light II*, the Idaho Supreme Court ruled that in order to rate base certain property held for future use a utility must demonstrate that the expenditures were “necessary and desirable from an economic standpoint.” 105 Idaho at 826, 673 P.2d at 426. The Court explained the expenditures in question met this standard because “they allow the company to take advantage of land opportunities that might otherwise be unavailable, allow the company

to escape purchasing property at inflationary prices, and are conducive to lower customer rates in the long run.” *Id.*

Avista’s purchase of CS2 was not “necessary and desirable from an economic standpoint.” Contrary to the facts in *Utah Power & Light II*, Avista’s purchase of CS2 at cost did not allow the company to escape making expenditures at inflationary prices and was not conducive to lower customer rates in the long run. Rather, Avista’s purchase at cost was in excess of CS2’s fair market value because the at-cost price included both an unreasonable initial price paid by Avista Power for CS2 and the overrun costs associated with numerous construction problems and delays while owned by Avista Power.

The initial price Avista Power paid sellers Portland General Electric and Enron for the partially completed CS2 and its turbine was unreasonably high. The total purchase price for the deal was approximately \$59.5 million for property that had an all-in cost (book value), including development costs, of approximately \$42 million. *Direct Testimony of Dennis E. Peseau on Behalf of Potlatch Corporation* (June 21, 2004) (“*Peseau Direct Testimony*”), p. 10. This price included a questionable \$3.5 million payment for a two-week put option agreement on the turbine just in case Avista Power wanted to back out of the deal. *Peseau Direct Testimony* at 9-10.

Cost overruns continued throughout Avista Power’s ownership of CS2 (July 2000 – December 2003) as it attempted to get the plant constructed and operational. Numerous construction and operational problems caused the estimated cost of Avista’s half of the plant to swell from approximately \$94 million to \$109 million. *Peseau Direct Testimony* at 11. Also during Avista Power’s ownership, imprudent natural gas swaps (discussed *infra*) produced losses in excess of \$62 million. *Peseau Direct Testimony* at 11-12.

Dr. Peseau concludes Avista's at cost purchase price of CS2 "is well in excess of fair market value." *Peseau Direct Testimony* at 13. Based on the Commission's own contemporaneous investigation into determining the cost of a comparable facility (with input from Avista), Avista's share of the fair market value of CS2 is \$84,560,000. *Peseau Direct Testimony* at 15. Yet Avista paid at least \$109 million for its half of the property. The excess costs (caused by the imprudent initial purchase by Avista Power and the problems that arose during Avista Power's ownership) are not properly included in rate base to be passed on to Avista's ratepayers.

Avista Power originally purchased CS2 as a merchant plant. Although Avista indicated its intention to purchase CS2 from Avista Power after screening responses to its 2000 RFP, the fact is that Avista did not make the purchase until January 1, 2003. During the intervening period that Avista Power owned the plant, Avista was under no legal obligation to buy and Avista Power was under no legal obligation to sell CS2. In fact, Avista Power tried to sell the plant to third parties prior to closing the eventual deal with Avista. Had this been an arms length transaction, Avista would never have volunteered to pay a price equivalent to the plant's excessive costs as of January 1, 2003. But for the need to relieve its affiliate of a no longer cost effective plant, Avista should have, and presumably would have, re-evaluated its options in early 2003 and selected a more cost effective course of action. The Commission should treat this transaction as if Avista had fulfilled its duty to the ratepayers by limiting the CS2 purchase price to fair market value at the time the purchase was made.

C. The Underlying Initial Cost Of CS2 Exceeded Net Book Value.

The fact that the initial purchase price of CS2 exceeded book value by \$17.5 million is further proof that the underlying cost of the initial purchase of CS2 by Avista Power is unreasonable (which directly contributes to the unreasonable at-cost price later paid by Avista).

Peseau Direct Testimony at 10. When a utility buys another utility, the Commission typically restricts the rate base additions to the purchased utility's rate base (i.e. net book value) even though the sale price often includes a premium for good will. Yet, un-refuted testimony by Dr. Peseau establishes that Avista Power paid \$59.5 million for a plant with a net book value of approximately \$42 million. *Peseau Direct Testimony* at 10. If Avista Power were a regulated entity, it would only have been able to recover the \$42 million in rate base. Now that a regulated entity, Avista, has purchased half of the property and wants to include the total cost in its rate base, the same rule should apply. Avista's rate base must be limited to the net book value of the asset it is acquiring.

D. "At Cost" Is Not Sufficient By Itself To Show A Purchase Was Reasonable And Prudent.

Due to the affiliate relationship between Avista and Avista Power, evidence showing Avista's purchase of CS2 occurred and was "at cost" is not sufficient to show it was reasonable and prudent. In *Boise Water I*, discussed *supra*, the Idaho Supreme Court reviewed the Commission's denial of the utility company's request to recover from ratepayers certain costs paid to its parent corporation. The Court found the company did not meet its burden of reasonableness simply by demonstrating the incurrence of the expense. *Id.* at 837. The Court explained:

The expenses charged to [the affiliate] in this appeal were largely for salaries paid to their employees, determined by [the affiliate], representing its own opinion of the reasonable value of the services rendered. There was no evidence supplied to substantiate that such charges—though "at cost"—reflected the reasonable market value for the services rendered.

Id. (emphasis added).

Likewise, here, Avista is attempting to include its full purchase price of CS2 in its rate base on the basis that the price reflects actual costs. Yet, Avista has not supplied evidence

sufficient to substantiate that the price paid to an affiliate for CS2—though “at cost”—reflected the reasonable market value for the property purchased. In fact, as explained above, the “at cost” price paid for CS2 exceeded the plant’s value at the time of purchase. *Peseau Direct Testimony* at 13-15.

E. Ratepayers Are Not Responsible For Excess Costs Incurred Before Avista Bought CS2.

In *Boise Water Corporation v. IPUC*, 99 Idaho 158, 578 P.2d 1089 (1978) (*Boise Water II*), the Idaho Supreme Court examined the proper way to allocate the increased value of property between shareholders and ratepayers. “Which class of persons receives the benefit of such revenue depends on who has borne the financial burdens and risks of that property.” *Id.* at 1092. The Court explained that, other than for real property, ratepayers acquire an interest in the value of property through depreciation payments. But, where ratepayers have not made such payments, as was the case for the real property at issue in *Boise Water II*, “ratepayers are not entitled to reap the rewards or losses on its sale or other transfer.” *Id.* at 1093. In *Boise Water II*, therefore, the Court concluded that the gain on the sale of real estate accrued to the stockholders, not the ratepayers.

Likewise, determining which class of persons receives the burden of a property’s decreased value “depends on who has borne the financial burdens and risks of that property.” Avista’s ratepayers did not hold any equitable interest in CS2, through depreciation payments or other investment, during the time in which the value of CS2 decreased (i.e. costs exceeded value). Therefore, Avista’s ratepayers are not “entitled” to receive the decreased value of this plant in the form of higher rates.

Instead, a pre-sale decrease in value is properly borne by the seller. Just as ratepayers would not earn an equitable interest in the increased value of property that occurred before the

utility purchased that property (because a fair market value sales price would allocate any pre-sale profit margin to the seller), they also do not inherit any escalation in the costs over value of that property that occurred before its purchase (because a fair market value sales price would allocate any pre-sale losses to the seller). In other words, a purchase price properly reflects current value, not total costs. These concepts are not complicated or unusual; rather, they are the assumed basic underpinnings of every fair, negotiated purchase transaction.

Avista's purchase of CS2 should have been no different. Avista should have paid the current value of the plant regardless of the plant's costs to date. Overruns in costs over value should have been borne by the seller, Avista Power. The fact that Avista is a regulated entity means that the Commission has a duty to make sure Avista's ratepayers are responsible only for reasonable expenditures for fair value. The fact that the seller here was an Avista affiliate intensifies the Commission's scrutiny of the deal to enforce that standard and places the burden on Avista to prove its price was fair and reasonable.

Avista's purchase of CS2 did not reflect these basic concepts of a fair, negotiated purchase. Avista bought CS2 from its unregulated affiliate after the affiliate seller had overpaid for the facility as an initial matter and after the construction costs associated with CS2 had escalated even further over its fair market value. *Peseau Direct Testimony* at 11-12. Yet, Avista improperly paid its affiliate a price based on the total costs of the plant, not based on its lesser fair value. This escalated purchase price is not properly included in rate base.

In sum, Avista has not met its burden to show the cost paid to its affiliate for CS2 was reasonable and prudent, and, thus, the "at cost" price is not appropriately included in rate base.

II. “DEAL A” AND “DEAL B” WERE UNNECESSARY AND IMPRUDENT EXPENDITURES, WHICH THE COMMISSION MUST DISALLOW.

A. To Protect Ratepayers From Unreasonable Rates, The Commission Must Disallow Unnecessary Or Imprudent Expenses.

To ensure rates are reasonable, a regulating commission has the authority and duty to oversee a utility’s underlying operating expenses. *Chicago & Grand T. Ry. v. Wellman*, 143 U.S. 339, 345-46 (1892) (“While the protection of vested rights of property is a supreme duty of the courts, it has not come to this: that the legislative power rests subservient to the discretion of any railroad corporation which may, by exorbitant and unreasonable salaries, or in some other improper way, transfer its earnings into what it is pleased to call ‘operating expenses.’”).

Given such commission oversight, a public utility company’s managerial discretion over operating expenses, though broad, is not limitless. If a utility company spends money unnecessarily or imprudently, then a commission should not allow such expenditures to be passed on to ratepayers. *Acker v. United States*, 298 U.S. 426 (1936) (rejecting certain marketing costs incurred for stockyards on the grounds that they were extravagant and wasteful); *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930) (finding that telephone company’s annual depreciation charge was excessive). In *Acker*, the United States Supreme Court explained the role a commission plays in protecting ratepayers from unnecessary and imprudent expenses:

The contention is that the amount to be expended for these purposes is purely a question of managerial judgment. But, this overlooks the consideration that the charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any other purposes.

Id. at 430-31.

Likewise, the Idaho Supreme Court has recognized the Commission’s broad authority to “supervise and regulate every public utility in the state and to do all things necessary to carry out the spirit and intent of the Public Utilities Law.” *Industrial Customers of Idaho Power v. IPUC*,

134 Idaho 285, 289, 1 P.3d 786, 790 (2000) (citing Idaho Code § 61-501). The Court specifically recognized the Commission's authority and responsibility to ensure rates are just and reasonable. *Id.* (citing Idaho Code § 61-222).

Although the initial burdens of proof differ in a commission's review of affiliate versus nonaffiliated expenses, the legal standard to which a commission must hold those expenses is the same. Regardless of who receives the money, a commission must determine whether a regulated entity's expenditures are necessary and prudent and thus properly borne by ratepayers.

Thus, here, the necessary and prudent legal standard controls the Commission's review of both Deal A expenses (paid by Avista to a non-affiliate) and Deal B expenses (paid by Avista to an affiliate, Avista Energy). In Deal A, the Commission bears the initial burden of showing the expenditures were either unnecessary or imprudent, and, in Deal B Avista bears the initial burden of showing the Deal B expenditures were both necessary and prudent. *Boise Water II*, 99 Idaho at 1091; *Boise Water I*, 97 Idaho at 836. Deal B also calls for heightened Commission scrutiny to protect ratepayers from potential intra-company self-dealing. *Boise Water I*, 97 Idaho at 837.

B. Deal A and Deal B Expenses Were Unnecessary And Imprudent.

Based on the extreme market conditions and prices at the time, a reasonable investor would not have bought the long-term hedge bets of Deals A and B. Indeed, all of the reasons for which PUC staff found Deal B to be economically unreasonable also apply to Deal A. Both deals involved hedged bets on the same fixed price of gas. Both deals took place when that price was at a near record level. *Peseau Direct Testimony* at 23. Both deals involved purely financial hedges and no actual physical purchase of gas. *Peseau Direct Testimony* at 24-25. In fact, Deal A's longer timeframe makes it more economically unreasonable than Deal B (36 months versus 17 months).

Therefore, it is no surprise that Deals A and B resulted in excess natural gas costs of \$62 million and that at no time were Deals A and B profitable to Avista. *Peseau Direct Testimony* at 17. To the contrary, Deals A and B were very profitable to the counter parties in the deals (including Avista shareholders who were counter parties to Deal B) at the expense of Avista's ratepayers, if allowed. *Peseau Direct Testimony* at 17.

Significantly, Avista cannot demonstrate that it pre-evaluated the cost-effectiveness of Deals A and B. In *Industrial Customers*, the Idaho Supreme Court held that certain demand side management ("DSM") expenditures were prudent based on evidence showing the utility had pre-evaluated the cost-effectiveness of the DSM programs. *Id.* at 292-93, 1 P.3d at 793-94. This evidence included company reports of the DSM programs' cost-effectiveness and Commission testimony that the company sought Commission approval before making the expenditures.

Avista has not provided any evidence showing that it pre-evaluated the cost-effectiveness of Deals A and B. In fact, as discussed already, a reasonable person could not have determined these expenses would be cost-effective given the market and price conditions at that time and the unprecedented length of the purely financial hedges. *Rebuttal Testimony of Dennis E. Peseau on Behalf of Potlatch Corporation* (July 14, 2004) (*Peseau Rebuttal Testimony*), p. 5. And, as this Commission has stated in another case, "it is inappropriate to lock in high prices solely for the sake of stability." *In the Matter of the Application of Intermountain Gas Company for Authority to Increase its Purchased Gas Cost Adjustment (OGA) Rate*, Order No. 29540, p. 4.

Avista argues that it pre-evaluated the deals in dispute and determined they could cost effectively generate electricity at then prevailing forward prices. But this argument only makes sense as a justification for the underlying physical purchases of the gas. An evaluation of the hedges at issue in this case would have required a detailed analysis of the propriety of taking a

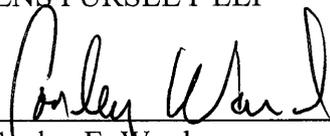
price position, as well as the costs and benefits of doing so. Avista conducted no such analysis on its ratepayers' behalf.

The only analysis it undertook was on behalf of its shareholders when it decided to take the opposite side of the Deal B hedge. Perhaps the most significant fact showing the imprudence of Deals A and B, as well as the improper self-dealing of Deal B, is that Avista itself expected gas prices to go down, as evidenced by the opposing hedge of its supposed expert purchasing arm (Avista Energy) in a deal with similar price terms and market conditions (Deal B). Yet, even with this knowledge, Avista still gambled (with ratepayers money) that gas prices would continue to rise and then stay high for the length of the hedge.

In sum, the Commission has no basis for finding that costs associated with Deals A and B can be passed on to ratepayers as necessary and prudent expenditures. The Commission has no evidence, from Avista or otherwise, that Avista's purchase of high-priced hedges for unprecedented terms was either reasonable or subjected to any pre-evaluation review as being cost-effective. Therefore, both Deal A and Deal B costs are inappropriate for recovery from ratepayers.

RESPECTFULLY SUBMITTED This 15th day of July 2004.

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 15th day of July 2004, I caused to be served a true and correct copy of the foregoing document by the method indicated below, and addressed to the following:

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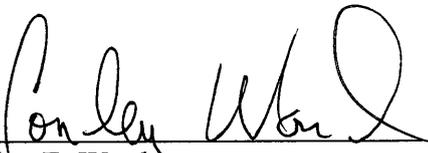
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