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IDAHO PUBLIC
UTILITIES COMMISSION

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 **POTLATCH CORPORATION'S ANSWER AND CROSS-PETITION FOR RECONSIDERATION**

Potlatch Corporation ("Potlatch"), pursuant to Rule 331.02 of the Commission's Rules of Practice and Procedure, respectfully cross-petitions this Commission for reconsideration of Order No. 29602 previously entered in the above-entitled case. Specifically, Potlatch requests reconsideration of that portion of Order No. 29602 that disallows only one-third of the losses associated with Avista's natural gas transaction identified in the record as "Deal A." Potlatch respectfully submits that, as both a matter of law and a matter of equity, the entirety of the Deal A costs must be disallowed for ratemaking purposes.

CROSS-PETITION

Perhaps the most fundamental principle of regulatory law is the maxim that a regulated utility's rates and charges ". . . shall be just and reasonable. Every unjust or unreasonable charge made, demanded or received for such product or commodity or service is hereby prohibited and declared unlawful." Idaho Code § 61-301. This "just and reasonable" rate standard necessarily assumes reasonable managerial competence and prudence. If a utility company spends money unnecessarily or imprudently, such expenditures cannot 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.

The Idaho Supreme Court has likewise repeatedly held that 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 II*") (citing *Citizens Util. Co. v. IPUC*, 99 Idaho 164, 171, 579 P.2d 110, 117 (1978)); *see also Boise Water Corporation v. IPUC*, 97 Idaho 832, 836, 555 P.2d 163 (1976) and *Washington Water Power Co. v. Kootenai, etc.*, 99 Idaho 875, 880, 591. P.2d 122 (1979) (dicta).

The overwhelming weight of the evidence of record is that the Deal A natural gas hedge was reckless and imprudent in the extreme. Avista's defense of Deal A amounts to nothing more than the assertion that it "provided the <u>necessary</u> gas supply, at a fixed cost, to fuel a <u>needed</u> generation plant." Avista Corporation's Petition for Reconsideration at 5 (emphasis original). The short answer to this assertion is that it is never appropriate for a utility to take a price position under the circumstances Avista was facing when it entered into Deal A. 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.

Furthermore, Avista's justification for Deal A has all the earmarks of an *ex post facto* invention. As the Commission noted in its Order,

> The paper trail that the Commission and our auditing Staff rely on for gas benchmark transactions was not present for Deal A and B. The appearance at hearing was that the justification for the transactions was cobbled together after the fact. Other than a notational entry that the financial hedges were required by lenders to obtain construction financing (financing that was ultimately not secured) there was no lender documentation to support such a requirement.[1]

Order No. 29602 at 45.

But even more damning is the fact that, as Dr. Peseau's testimony points out, Deal A did not in fact lock in a physical purchase of gas as Avista's Petition alleges. The physical purchase had already been made. What Deal A did lock in was an immediate gamble on the price direction of the natural gas futures market; and that gamble led to immediate losses long before physical purchases were actually made. *Peseau Direct Testimony* at 19, 24-25. The length of the deal and the financial exposure it created were unprecedented for Avista. *Peseau Direct Testimony* at 27. Furthermore, Deal A was unprecedented in the industry as a whole. Dr. Peseau examined the FERC database of 37,472 natural gas hedges entered into in May of 2001 and found none with even half the duration of Deal A's 36 months. *Peseau Direct Testimony* at 25.

Incredibly, this risk was assumed without any formal cost benefit analysis of the sort that is normally a matter of course when a utility undertakes a major expenditure or risk. *See e.g.,*

[1] It is worth noting that Avista's Petition for Reconsideration does not offer to produce any additional documentation to rebut this Commission finding.

Industrial Customers of Idaho Power v. IPUC, 134 Idaho 285, 292-293, 1 P.3d 786, 793-794 (2000) (demand side management ("DSM") expenditures were prudent based on evidence showing the utility had pre-evaluated the cost-effectiveness of the DSM programs). Avista's Petition for Reconsideration merely repeats its earlier arguments that its analysis demonstrated that the "fixed" gas price would produce electricity at prices below the then existing electric market projections. Avista Petition at 6-8. This analysis would perhaps have some relevance if Avista had been considering a fixed price, long-term purchase of natural gas for contemporaneous electric generation. But this analysis was totally inadequate when considering a separate <u>hedge</u> of natural gas prices because the use of this derivative introduced a new and unique element of risk, *i.e.*, with the natural gas hedge Avista would incur immediate profits or losses, depending on which way the market moved, long before payment for physical gas deliveries would otherwise have been required.

Taking on this "derivative" risk without evaluating it as an exposure separate and distinct from the physical purchase of gas was not only imprudent, it was specifically prohibited by Avista's risk management policies, as Dr. Peseau's quotation from the company's Risk Policy makes abundantly clear:

> Any incremental market exposure created from the use of derivatives is inconsistent with the risk management objectives of this Policy <u>and is not permitted.</u> <u>The use of derivatives</u> exposes Avista Corp. to risks similar to risks of physical products, and <u>may have additional liquidity, settlement, legal, and systematic risk attributes</u>. Even the proposed use of derivatives that would hedge risks should be assessed against these additional risks, and such use is permitted only to the extent that the expected benefit is considered to outweigh these risks.

Peseau Rebuttal Testimony at 5 (emphasis added). Deal A imposed exactly the type of "additional liquidity, settlement, legal, and systematic risk(s)" described in the Risk Policy because it impacted Avista's liquidity by requiring immediate settlements rather than paying for gas as delivered, and it introduced the additional legal risk associated with a potential default of the party to the hedges. Neither Avista's evidence at hearing nor its Petition for Reconsideration makes even a colorable claim that these risks were assessed separately as required by the company's Risk Policy.

Under these circumstances, the Commission's disallowance of one third of Deal A's costs is a wholly inadequate remedy. Deal A was imprudent and "not permitted" under the Company's Risk Policy, and it should similarly be "not permitted" for ratemaking purposes. The Commission can have no basis for finding that any portion of the costs associated with Deals A can be passed on to ratepayers as necessary and prudent expenditures. That being the case, recovery of any portion of these costs is an unjust and unreasonable charge that is precluded as a matter of law. The Commission simply doesn't have authority to attempt a middle approach that attempts to give something to both the utility shareholders and its ratepayers. The Deal A losses must be left with the utility whose incompetence and recklessness caused their incurrence. They cannot be foisted, in whole or in part, on innocent ratepayers who had no role in Avista's unilateral error in judgment.

ANSWER

Potlatch supports the Commission's disallowance of a portion of the Boulder Park costs. The simple fact is that Boulder Park's costs were wildly excessive when compared to any reasonable cost overrun possibilities. Clearly if Boulder Park had been purchased from an independent third party contractor, it would have been unreasonable for Avista not to cap any potential cost overruns by contract. It is not unreasonable for the Commission to impose a similar overrun limitation on plants built by Avista.

CONCLUSION

Potlatch respectfully requests that the Commission confirm its original disallowance of a portion of the Boulder Park costs and modify its original order to disallow the entirety of Deal A's costs for ratemaking purposes. Potlatch does not intend to submit new evidence on these issues, nor does it request further proceedings.

RESPECTFULLY SUBMITTED this 5th day of November 2004.

GIVENS PURSLEY LLP

By ______________________
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 5th day of November 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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