Decision **PROPOSED DECISION OF ALJ WALKER** (Mailed 2/15/2005)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Avista Corporation (U 907 G), a Washington corporation, and Southwest Gas Corporation (U 905 G), a California corporation, for authority to sell interests in utility property pursuant to the provision of Section 851 of the Public Utilities Code of the State of California.	Application 04-09-009 (Filed September 3, 2004)

Bridget A. Branigan, Attorney at Law, for Southwest Gas Corporation,
David J. Meyer, Attorney at Law, for Avista Corporation, applicants.
Patrick Gileau, Attorney at Law, for the Office of Ratepayer Advocates, protestant.

OPINION APPROVING SETTLEMENT AND GRANTING AUTHORITY FOR PROPOSED ACQUISITION

1. Summary

Avista Corporation (Avista) and Southwest Gas Corporation (Southwest) seek approval for Avista to sell its South Lake Tahoe gas facilities to Southwest. The Office of Ratepayer Advocates (ORA) protested the application, seeking protection against rate increases for the current Avista gas customers. This decision approves a settlement agreement among the parties that protects current Avista customers from an increase in gas base rates through at least 2008. Under Pub. Util. Code §§ 2001 and 2004, we authorize the acquisition of Avista's California gas facilities by Southwest. This proceeding is closed.

2. Background

Avista, with headquarters in Spokane, Washington, serves a total of 325,000 electric and 298,000 natural gas customers in the states of Washington, Idaho, Oregon and California. The company's only gas distribution service in California is in its South Lake Tahoe District, where it serves 16,200 customers. Avista has been serving South Lake Tahoe since 1991, when it acquired certain Oregon and California natural gas assets from CP National Corporation.

Southwest, a California corporation, serves 1.6 million customers in the southwestern United States. It currently serves more than 22,000 natural gas customers in its Northern California Division, which is concentrated in the Lake Tahoe Basin, and another 118,000 customers in its Southern California Division, which is in San Bernardino County.

On July 21, 2004, Southwest and Avista entered into a purchase and sale agreement, subject to regulatory approval, by which Southwest would acquire Avista's South Lake Tahoe natural gas assets for approximately $15 million. The assets include 654,000 feet of steel mains, 576,000 feet of plastic mains and 19,000 meters.

In prepared testimony, Kelly O. Norwood, Avista's vice president of state and federal regulation, explained the reasons for the sale:

> The South Lake Tahoe service territory is isolated from Avista's other service territories in Washington, Idaho and Oregon, and is the only area served by Avista in California. The sale of the properties is consistent with Avista's strategy to focus on its utility business in the Northwest. Furthermore, Southwest has been serving much of the Lake Tahoe Basin for 40 years, and the South Lake Tahoe community is contiguous to existing Southwest service territories. The South Lake Tahoe properties would be complementary to the existing areas already served by Southwest. (Norwood testimony, Exhibit 4, at 5.)

Roger C. Montgomery, vice president of pricing for Southwest, stated that the acquisition will provide a number of advantages for current Avista customers in South Lake Tahoe. First, Southwest has a greater number of employees in closer proximity to South Lake Tahoe than Avista (24 as compared to 7 in the South Lake Tahoe/Truckee area) and, as a result, customer service and emergency response should be augmented. Second, Southwest has equipped meters in its Northern California District with electronic reading technology that permits one meter reader to read all meters in the district "with virtually 100 percent accuracy." Southwest intends to employ the same technology in South Lake Tahoe. Third, Southwest offers a number of customer options that are not currently offered by Avista, including appointment window scheduling, natural gas outdoor lighting and more generous credit terms, and Southwest intends to make these services available over time to South Lake Tahoe. (Montgomery testimony, Exhibit 3, at 5-6.)

3. Procedural Background

A Prehearing Conference in this matter was conducted on November 30, 2004, at which time the parties reported that settlement discussions were in progress. Avista stated that it had notified customers of the proposed acquisition through newspaper advertisements. It was asked to include an announcement of the proposal in a bill insert approved by the Commission's Public Advisor, and this was subsequently done. No customer has protested the proposed transaction.

On January 11, 2005, the parties filed a settlement agreement and jointly moved for its approval. A settlement hearing was conducted on January 14, 2005, in which three witnesses described the terms of the proposed acquisition and the settlement and answered questions posed by the

Administrative Law Judge (ALJ) and an Energy Division advisor. At the conclusion of the settlement hearing, the proceeding was deemed submitted to the Commission for decision.

4. ORA Investigation and Settlement

ORA's investigation addressed the overall impact of Southwest's proposed acquisition on the rates of Avista's existing customers, the quality of service that those customers can expect, and the operational and financial ability of Southwest to serve the California territory it intends to acquire.

4.1 Base Margin Rates

Based on current tariff schedules of the applicants, Southwest's Northern California Division base margin residential rates (non-gas costs) are higher than Avista's base margin residential rates for South Lake Tahoe. In the application, Southwest committed to maintaining South Lake Tahoe as a separate rate area and stated that it would not seek to consolidate base margin rates in a future rate case until it can show that consolidation would provide an overall benefit to customers.

To provide further assurance that base margin rates will not be affected, the settlement agreement provides that Avista's existing base margin rates will remain unchanged until new rates are established in a future general rate case. Further, the parties agreed that Southwest within 30 days would file, and ORA would support, a separate application that would continue Avista's base margin rates in the South Lake Tahoe service territory for an additional two years beyond 2007. Currently, the test year for Southwest's next general rate case is 2007. In its filing, Southwest will ask authority (1) to extend the test year until 2009 and (2) to implement attrition adjustments in its Northern and Southern California Divisions for 2007 and 2008 consistent with the method

approved by the Commission in Southwest's last general rate case (Decision (D.) 04-03-034). Any such attrition adjustments will not be applicable to base margin rates for the South Lake Tahoe service territory being purchased by Southwest.

The settlement agreement provides that the base margin rates for Avista's South Lake Tahoe service territory will remain unchanged for the years 2005, 2006, 2007 and 2008. ORA comments that this rate freeze will result in significant economic benefits for customers, since the most recent estimates of consumer price increases over those years are 2.2% in 2005, 1.3% in 2006, 1.7% in 2007 and 1.9% in 2008 (based on November 2004 forecasts of Global Insight, U.S. Economic Outlook). According to Southwest's witness, the rate freeze also provides an incentive for Southwest to operate as efficiently as possible.

4.2 Acquisition Premium

Southwest originally proposed that it not be foreclosed from seeking in a future rate case to recover the acquisition premium related to this transaction, although it pledged that no such recovery would be sought until it could demonstrate acquisition-related savings in the cost of service. The acquisition premium (the difference in the purchase price and the net asset value of the property) is approximately 28%.

ORA opposed potential future recovery of an acquisition premium, citing Commission practice to exclude for recovery from customers any premium paid by a utility to acquire another utility's operations. According to ORA, this practice reinforces the policy that ratepayers should only have to pay the original cost of the property first devoted to utility service.

The parties agreed that a request for recovery of the premium would likely be controversial and litigious. The settlement agreement negotiated between the

parties provides that Southwest will not seek Commission authority to recover the acquisition premium in this or in any future regulatory proceeding.

4.3 Avista's Gas Costs

The application requests that the Commission, in its order approving this transaction, include a finding that the costs of Avista's natural gas purchases were prudent up to the date of the Commission's decision. Southwest explained that it needed assurances that it would not be held liable for any potential gas purchase cost disallowance for the time it did not own and operate the South Lake Tahoe system.

In D.95-10-045, as modified by D.97-04-047, Avista's Purchased Gas Cost Adjustment (PGA) mechanism was suspended and set to zero. This suspension was in place from April 1997 through December 2000. Since Avista bore all the risk of gas purchases during that period, ORA in its analysis began with gas purchases made by Avista from January 2001, when the PGA was reinstated. ORA reviewed information provided by Avista regarding its gas purchasing practices and strategies, including detailed cost information, sample invoices, and recorded monthly PGA account activity. Avista provided information to ORA through October 2004 and is to continue to provide updated documentation as additional information becomes available.

ORA states that it identified no specific issues related to Avista's gas purchasing that it intended to pursue through litigation and concluded that it did not intend to propose any ratemaking adjustments to Avista's PGA account for the relevant period of January 2001 through October 2004. ORA states that it will continue to review Avista's gas purchasing data for the period November 2004 through the conclusion of this proceeding and will advise the applicants and the Commission of the results of its review.

Based on ORA's investigation, our order today concludes that Southwest's gas purchases were prudent for the period January 2001 through October 2004. Avista testified at the settlement hearing that its procedures for gas purchase will be unchanged for the period October 2004 through the date of this decision, and we conclude that, barring some unlikely development, the purchases during that period also are prudent.

4.4 Portfolio Consolidation

The applicants propose that Southwest be allowed to consolidate its natural gas purchases for the South Lake Tahoe customers with its existing northern California gas purchases. Southwest operates in both northern Nevada and northern California. Both of these service areas use similar mixes of interstate capacity and supply sources, allowing Southwest to purchase the natural gas portfolios for both areas concurrently. According to applicants, the consolidation of the gas purchases for South Lake Tahoe with Southwest's existing natural gas purchases for northern Nevada and northern California should result in greater efficiencies and economies of scale.

ORA states that the proposed consolidation of natural gas purchases is reasonable, should be approved by the Commission, and should become effective once the transfer is approved. It adds that although the number of natural gas pipelines and suppliers is limited in the Tahoe Basin area, the purchasing power from the combined portfolios could potentially increase the number of suppliers bidding to supply natural gas to the area and may lead to lower prices for ratepayers in the long term.

In addition, the parties in the settlement agreement recommend that the Commission authorize Southwest to include the Avista service territory in Southwest's July 2005 PGA rate change. At that time, the gas cost and gas cost-

related balancing accounts will be merged, and all of Southwest's northern California customers would pay the same cost for gas. The parties also recommend that, in the event the Commission authorizes Southwest to implement a gas cost incentive mechanism in its pending application (Application 04-11-009), the mechanism should be applicable to the South Lake Tahoe service territory.

Our order today adopts these proposals as reasonable.

4.5 Tariff Applicability

The applicants seek Commission authorization to use Southwest's terms and conditions contained in its California tariffs in lieu of the terms and conditions now contained in Avista's California tariffs (except for base margin rates). The applicants state that the terms and conditions in both sets of tariffs are virtually identical.

Specifically, applicants ask that Southwest's California Tariff Rules Nos. 1 through 22 be applicable to the South Lake Tahoe customers in lieu of Avista's currently effective California Tariff Rules Nos. 1 through 21. The Preliminary Statements and Rate Schedules in the existing Avista tariffs would remain in place in order to maintain the rates currently paid by Avista customers.

ORA states that it has examined the tariffs and agrees that there are no significant differences. The Southwest tariffs in fact offer additional service choices to customers. Accordingly, ORA recommends that Southwest should be allowed to substitute its California Tariff Rules for the existing Avista California Tariff Rules. We agree.

5. Discussion

As applicants point out, Southwest's acquisition of Avista's South Lake Tahoe gas facilities makes sense from a corporate point of view. Avista divests

itself of a geographically remote service district and concentrates on its major gas distribution operations in the states of Washington, Idaho and Oregon. Southwest acquires 18,600 new customers in a service area contiguous to its northern California service area that already has 22,000 natural gas customers.

The acquisition also makes sense from a customer point of view. Avista's customers will be served by a much larger local staff and this is likely to improve customer service and emergency response. Moreover, Southwest has more than 50 years of experience in operating natural gas distribution systems that serve 1.6 million customers in the southwestern United States, including 140,000 in California. With its larger presence in California, Southwest should be able to save ratepayers money through economies of scale and greater bargaining power in the purchase of natural gas.

ORA has done a thorough analysis of this transaction and, together with the other parties, has negotiated a settlement agreement that freezes base service gas rates for Avista customers through the year 2008. The settlement agreement also guarantees that the acquisition premium paid by Southwest will not be passed on to customers in this or any future proceeding.

We agree with ORA that it is in ratepayers' interest to permit Southwest to consolidate its natural gas purchases for the South Lake Tahoe customers with its existing northern California gas purchases, and to include the Avista service territory in Southwest's monthly purchased gas adjustment mechanism. Similarly, in the interest of uniformity, Southwest will be authorized to substitute its tariff rules for those of Avista, except for the base margin rates.

Southwest states that it will initially fund the acquisition of the South Lake Tahoe properties with working capital. The permanent financing of the acquisition will be obtained in the same manner as the funding for Southwest's

utility plant capital expenditures, that is, through internally generated funds (retained earnings and depreciation) and external sources of funds (debt and equity).

Avista and Southwest issued separate press releases announcing the transaction in July 2004 and distributed to their 14 local news outlets. In addition, Avista advised all of its South Lake Tahoe customers of the proposed sale in a bill insert approved by our Public Advisor's office. No customer has objected to the proposed sale.

6. Jurisdictional Review

The joint application was filed under Pub. Util. Code § 851, which governs the sale or other disposition or encumbrance of public utility property. Southwest takes the position that § 854 of the Code (governing acquisition or control of a public utility doing business in California) does not apply since Southwest is acquiring only about 1% of Avista's assets.

Pub. Util. Code § 854 requires Commission authorization before a company may "merge, acquire, or control…any public utility organized and doing business in this state…." The purpose of this and related sections is to enable the Commission, before any transfer of public utility authority is consummated, to review the situation and to take such action, as a condition of the transfer, as the public interest may require. (*San Jose Water Co.* (1916) 10 CRC 56.)

Historically, the Commission has determined the applicability of § 854 on a case-by-case basis. We believe that § 854 applies to this proceeding. While only about 1% of Avista's assets are being transferred, Southwest is taking over all of Avista's public utility operation in California. Southwest has asked for, and we will grant, the transfer of Avista's certificate of public convenience and necessity

to serve the South Lake Tahoe district. While the transaction may be minimal as far as Avista's total holdings are concerned, it is a substantial transfer in California, since the entire Avista service territory in this state will be conveyed to another public utility. Since the purpose of § 854 is to enable us to review and set conditions on the transfer of public utility authority in California, the transaction here falls within the meaning of § 854(a), although § 854(b) does not apply since neither Avista nor Southwest has gross annual California revenues exceeding $500 million. (*See, generally, Lodi Gas Storage* (2003) Decision 03-02-071, at 10-20.)

Fortunately, in an exercise of caution, Southwest and Avista in their application have supplied sufficient documentation for our review, and for ORA's review, under both § 851 and § 854 of the Code, and both we and ORA have examined the reasonableness of this transaction under both of these statutes.

7. Environmental Review

The application requests that the Commission find that the proposed transaction is not a project subject to the California Environmental Quality Act (CEQA), Cal. Pub. Resources §§ 21000, *et seq.*, or that the transaction is exempt under CEQA.

CEQA requires that we consider the environmental consequences of projects that are subject to our discretionary approval. (Pub. Resources Code Section 21080.) It is possible that a change of ownership and/or control may alter an approved project, result in new projects, or change facility operations, etc., in ways that have environmental impacts.

In this instance it is our understanding that the change in ownership will not result in any significant effect on the environment because the property will

be operated in the same manner as Avista has operated it, and the proposed transfer will result in neither a direct physical change in the environment nor a reasonably foreseeable indirect change in the environment. It can be seen with certainty that there is no possibility that the transaction before us will have a significant effect on the environment. Accordingly, we find that the transaction is exempt from further review by this Commission pursuant to CEQA Guideline 15061(b)(3).

8. Conclusion

We find it is in the public interest to approve the application and we do so, subject to the changes negotiated by ORA, Southwest and Avista in their settlement agreement.

The settlement agreement settles all issues between the applicants and ORA and provides significant base rate protection for customers affected by the acquisition. The criteria for settlements are set forth in Rule 51.1(e) of the Rules of Practice and Procedure (Rules), which requires that a settlement be reasonable in light of the whole record, consistent with law, and in the public interest. We conclude that the settlement agreement is consistent with these criteria, and we approve it in the order that follows. The settlement agreement is affixed to and made part of this decision as Attachment A.

In Resolution 176-3139, dated September 23, 2004, the Commission preliminarily categorized this proceeding as ratesetting, and preliminarily determined that hearings would not be necessary. In view of the ORA protest and settlement, a settlement hearing was conducted in order to question parties on settlement terms. We conclude that it is not necessary to alter the preliminary categorization of this proceeding, but we note that a hearing was deemed

necessary. Accordingly, the Rules and procedures in Article 2.5 apply fully to this formal proceeding.

9. Comments on Proposed Decision

The proposed decision of the ALJ in this proceeding was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were received on _____, and reply comments were received on _____.

10. Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner and Glen Walker is the assigned ALJ in this proceeding.

Findings of Fact

1. Avista serves 298,000 natural gas customers in the states of Washington, Idaho, Oregon and California.

2. Avista's only gas distribution service in California is in its South Lake Tahoe District, where it serves 16,200 customers.

3. Southwest serves 1.6 million customers in the southwestern United States, including 22,000 natural gas customers concentrated in the Lake Tahoe Basin in its Northern California Division.

4. On September 3, 2004, Southwest and Avista filed this application for authority for Southwest to acquire Avista's South Lake Tahoe gas assets for approximately $15 million.

5. ORA on October 3, 2004, filed a protest to the application.

6. On January 11, 2005, the parties filed a settlement agreement and jointly moved for its approval.

7. A settlement hearing was conducted on January 14, 2005, in which three witnesses described the terms of the proposed acquisition and the provisions of the settlement agreement.

8. Among other things, the settlement agreement would freeze the existing base margin rates for current Avista gas customers for the years 2005, 2006, 2007 and 2008.

9. The settlement agreement also provides that Southwest will not seek Commission authority to recover its acquisition premium in this or in any future regulatory proceeding.

10. ORA recommends approval of the application, as modified by the settlement agreement.

Conclusions of Law

1. The application, as modified by the settlement agreement, should be approved.

2. Avista's natural gas purchases for the period January 2001 through October 2004 were prudent and, barring some unexpected development, are likely to be deemed prudent for the period October 2004 to the date of this decision.

3. Upon consummation of this transaction, Southwest should be allowed to consolidate its natural gas purchases for South Lake Tahoe with its existing northern California gas purchases.

4. Southwest should be authorized to include the Avista service territory in Southwest's July 2005 purchased gas rate adjustment.

5. Southwest should be authorized to substitute its Tariff Rules Nos. 1 through 22 in lieu of Avista's Rules Nos. 1 through 21, retaining the Preliminary Statements and Rate Schedules in the existing Avista tariffs.

6. Pub. Util. Code §§ 851 and 854 govern this transaction.

7. This change of control qualifies for exemption from CEQA review under CEQA Guidelines Section 15061(b)(3).

8. The settlement agreement is reasonable in light of the whole record, consistent with law, and in the public interest.

O R D E R

IT IS ORDERED that:

1. The application of Avista Corporation (Avista) and Southwest Gas Corporation (Southwest) for authority for Avista to sell its South Lake Tahoe gas facilities to Southwest in accordance with the purchase and sale agreement attached to the application, as such agreement has been modified by a settlement agreement attached hereto and made part hereof as Attachment A, is approved.

2. The settlement agreement attached hereto and made part hereof as Attachment A is reasonable in light of the whole record, consistent with law, and in the public interest.

3. Pub. Util. Code §§ 851 and 854 govern this transaction.

4. The change in ownership of the South Lake Tahoe gas facilities qualifies for an exemption from the California Environmental Quality Act (CEQA) under CEQA Guidelines § 15301(b) and, therefore, additional environmental review is not required.

5. The cost of natural gas purchases by Avista was prudent and recoverable for ratemaking purposes prior to and through October 2004.

6. Upon consummation of this transaction, Southwest is authorized to substitute its Tariff Rules Nos. 1 through 22 in lieu of Avista's Rules Nos. 1

through 21, retaining the Preliminary Statements and Rate Schedules in the existing Avista tariffs.

7. Upon consummation of this transaction, Southwest is authorized to include the Avista service territory in Southwest's July 2005 Purchased Gas Cost Adjustment rate change, at which time the gas cost and gas cost-related balancing accounts will be merged, and all of Southwest's northern California customers will pay the same cost for gas.

8. Upon consummation of this transaction, and in the event the Commission authorizes Southwest to implement a gas cost incentive mechanism in its pending application (Application 04-11-009), the mechanism shall be applicable to the South Lake Tahoe service territory.

9. Upon consummation of this transaction, Southwest is authorized to consolidate its natural gas purchases for South Lake Tahoe with its existing northern California gas purchases.

10. Upon consummation of this transaction, the Certificate of Public Convenience and Necessity of Avista shall be transferred to Southwest, and Avista shall be relieved of its public utility obligation in California.

11. Southwest and Avista shall notify the Director of the Commission's Energy Division, in writing, of the transfer of ownership, as authorized herein, within 30 days of the date of transfer. A true copy of the instruments of transfer shall be attached to the notification.

12. The authority granted herein shall expire if not exercised within one year of the date of this order.

13. Application 04-09-009 is closed.

This order is effective today.

Dated _____, at San Francisco, California.

Attachment A