THE HACKETT GROUP, on behalf of itself and all others similarly situated, 

Plaintiff, 

v. 

AVISTA CORPORATION, THOMAS M. MATTHEWS and JON E. ELIASSEN, 

Defendants. 

No. CS-00-0262-RHW

FIRST AMENDED AND CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS

Jury Trial Demanded

I. NATURE OF THE ACTION

1. This is a proposed securities class action brought on behalf of all persons, other than defendants and affiliated persons as described below (the "Class"), who purchased or otherwise acquired the securities of Avista Corp.
(“Avista” or the “Company”), between April 14, 2000 and June 21, 2000 (the “Class Period”).

2. Prior to and during the Class Period, Avista and its officers represented that its division known as Avista Utilities was, in the words of defendant Thomas Matthews (its former CEO), a “stable” company with “minimal downside.” According to defendants, Avista Utilities, as a regulated utility, was “stable” because it was essentially a state-licensed monopoly for a basic necessity (electricity) that had very stable demand. Further, the price of electricity was set by the state to allow recovery of all costs, plus a reasonable return to shareholders. Thus, a reasonable return to shareholders was virtually guaranteed unless the Company deviated from its business model of generating electricity and selling it to its residential and business customers.

3. Prior to the beginning of the Class Period, the defendants repeatedly represented in filings with the Securities Exchange Commission (“SEC”) and in other publicly filed documents that any derivative transactions Avista Utilities might enter into would be risk-minimizing rather than speculative, and would be made only for the limited purposes of more efficiently running its power plants and to hedge against changes in the market price of electricity. Specifically, Avista represented in its 1999 annual report on Form 10-K filed with the SEC that Avista Utilities entered into certain derivative transactions to “optimize system resources,” or to “manage the risks associated with market fluctuations in the price of electricity and natural gas.” The Form 10-K specifically represented that “Commodity instruments are not generally held by Avista Utilities for speculative trading purposes.” Avista Utilities Resource Optimization Risk Policy, as publicly filed with the State of Washington, provided further specific guidance as to reasons derivative contracts could be entered into, as well as the maximum level of risk that would be tolerated. This policy stated,
in no uncertain terms, that futures contracts could be used only for “hedging physical purchases and sales.” Sworn public testimony of Avista’s CEO further maintained that derivatives were used exclusively for “system optimization.” In its Form 10-Q filed with the SEC on May 12, 2000, defendants represented that these transactions had not increased Avista’s market risk. In short, Avista Utilities consistently maintained that derivative transactions were never used by the Company for speculative purposes.

4. The Company further maintained that its market risk exposure as a result of derivatives would be “actively managed with strict policies designed to limit the exposure to market risk.” Avista represented that it had an elaborate system of internal controls so that unauthorized derivative trading could not occur at the Company.

5. An unsuspecting stock market had no reason to disbelieve these multiple assertions, and considered Avista as a “stable” investment due, in part, to the safety of revenues and returns from Avista Utilities.

6. The Class Period commences on April 14, 2000, by which time Avista Utilities had covertly entered into large quantities of derivative contracts – not for the purpose of hedging or limiting exposure to market risk or optimizing system resources – but for exactly the opposite purpose, to speculate on the price of energy as a means of improving their net income. These contracts provided for Avista to sell large quantities of electricity to customers far into the future at prices that were fixed as of the contract date, while obligating Avista to purchase this same electricity at market prices existing at the time of the purchase. These contracts were highly speculative in nature and rendered the previous assertions regarding Avista Utilities’ derivative transaction policies, as well as Avista Corp.’s and Avista Utilities’ systems of internal control, materially false and misleading. No mention of the improper
transactions or changes in the Company's risk policies or internal controls was ever made – until the Company had lost $140 million from these speculative trades.

7. By entering into the derivative contracts, Avista was gambling (with other people's money), that energy prices would decrease during the interim period between the time when Avista entered into the contracts and when it actually had to deliver the products. Then, Avista would be able to buy the electricity in the open market at the lower prices, and sell it at the fixed higher prices under the contract.

8. These derivative transactions were not for "hedging" or "system optimization" needs. Rather, they were entered into for purely speculative purposes, as would later be admitted by a Vice President of Avista Utilities in sworn testimony before a state regulatory commission. Essentially, these derivative contracts amounted to no more than a massive undisclosed gamble that the price of electricity would fall, or at least remain stable through October of 2000. But the shareholders – whose money was financing this elaborate gamble – were never told of the risks the Company had decided to take.

9. Unfortunately for Avista's shareholders, the bet they had taken but been unaware of but which had been made with their money failed miserably. Avista was locked into speculative derivative contracts that required Avista to pay prices averaging $60 per megawatt in May and over $100 per megawatt in June for power it was contractually obligated to sell at far lower prices.

10. Because of the Company's elaborate system of internal controls, management and the individual defendants were aware almost immediately of the nature and extent of the April 14, 2000 derivative contracts. The week after the derivative contracts were entered into (no later than April 19, 2000), Avista Utilities management was aware of both the nature and magnitude of the contracts and the risks associated with them, but chose to keep them hidden from public scrutiny.
Defendant Matthews himself admits to knowing about the contracts by at least May 25, 2000, and acknowledges that other senior management knew at least two and one-half weeks earlier. By that time, there were already significant losses from the speculative positions, but defendants decided to covertly keep the gamble going in an apparent effort to recoup the losses prior to June 30, 2000, when accounting rules would force their disclosure. If the gambling losses could be recouped by then, the market would never be the wiser about the derivative contracts, or the defendants’ role in them. One of the most familiar gambling adages is that chasing losses in an attempt to get even is a foolish strategy – and gambling in energy derivatives proved to be no exception to this maxim. Power prices continued to escalate during June, causing even larger losses. By June 21, 2000, Avista Utilities had lost $140 million – at least 60% of which was attributed to improper derivative trading by defendant Eliassen. These massive gambling losses not only caused huge unforeseeable losses within the regulated utility division, they eliminated all the profits of Avista Corp. for the second quarter and the entire year of 2000.

11. By June 21, 2000, it was clear that no gambling strategy could recover the losses that had already been suffered by June 30, 2000, when accounting rules would force their disclosure. With no remaining options, defendants were forced to finally come clean about the massive gambling losses experienced by Avista Utilities.

12. Following the disclosure of the elimination of all of Avista’s annual profits, Avista’s stock price, which closed at $37-11/16 per share on the day prior to the class period, closed at $19.00 per share on June 21, 2000 – resulting in a loss of more than $800 million in market capitalization to the shareholders of Avista during the Class Period.
II. JURISDICTION AND VENUE


14. Plaintiff brings this action pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder by the SEC.

15. Venue is proper in this District pursuant to Section 27 of the Exchange Act, and 28 U.S.C. §§ 1391(b) and (c). Many of the acts and transactions giving rise to the violations of law complained of herein occurred in this District. In addition, Avista maintains its corporate headquarters and executive offices at 1411 East Mission Avenue, Spokane, Washington – within the Eastern District of Washington.

16. In connection with the acts and conduct alleged in this Complaint, defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including the mails and telephone communication systems, and the facilities of a national securities market.

III. THE PARTIES

17. Lead Plaintiff The Hackett Group consists of the following three shareholders:

   (a) Plaintiff The Hackett Foundation purchased 3,000 shares of Avista stock on April 17, 2000 at $39.50 per share and has been damaged as a result of defendants’ conduct as described herein.

   (b) Plaintiff Anthony Cafaro made the following purchases of Avista stock during the Class Period, and has been damaged as a result of defendants’ conduct as described herein:
1 Shares Date Purchase Price
2 2,000 4/25/2000 27.00 per share
3 1,000 5/05/2000 26.00 per share
4 1,000 5/23/2000 22.56 per share
5 1,000 6/20/2000 18.75 per share
6 300 6/20/2000 18.63 per share
7 1,700 6/20/2000 19.13 per share
8 1,000 6/21/2000 16.88 per share

(c) Plaintiff Frank Toplak made the following purchases of Avista stock during the Class Period, and has been damaged as a result of defendants’ conduct as described herein:

<table>
<thead>
<tr>
<th>Shares</th>
<th>Date</th>
<th>Purchase Price</th>
</tr>
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<tbody>
<tr>
<td>1,000</td>
<td>4/18/2000</td>
<td>32.88 per share</td>
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<td>1,000</td>
<td>4/26/2000</td>
<td>30.25 per share</td>
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<tr>
<td>1,000</td>
<td>4/28/2000</td>
<td>30.25 per share</td>
</tr>
<tr>
<td>500</td>
<td>6/21/2000</td>
<td>18.13 per share</td>
</tr>
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18. Defendant Avista Corporation is a Washington corporation with its principal offices within this judicial district at 1411 East Mission Avenue, Spokane, Washington 99202. Avista’s common stock trades on the New York Stock Exchange under the symbol “AVA.” The Company files annual, quarterly and other reports with the SEC in accordance with the Exchange Act.

19. At all times during the Class Period, defendant Thomas M. Matthews (“Matthews”) was President, Chief Executive Officer and Chairman of the Board of Directors of the Company. Subsequent to the Class Period, by November 14, 2000, defendant Matthews left the Company in all of these capacities. Because of his position with the Company during the relevant period, defendant Matthews had
access to the material, adverse, non-public information about Avista’s internal control structure, as well as the Company’s finances, and had access to internal corporate documents (including the Company’s operating plans, budgets and forecasts, and reports of actual operations compared thereto), conversations and communications with other corporate officers and employees, attendance at management and Board of Directors’ meetings and committees thereof, and via reports and other information provided to him in connection therewith, and directly communicated with securities analysts regarding Avista’s business and financial condition.

20. Defendant Matthews commenced his employment with Avista on July 1, 1998. Matthews signed an Employment Agreement with Avista calling for him to receive: (i) a $1 million signing bonus; (ii) a restricted stock award of $2 million (as of July 1, 1998, vesting 1/3 each after his third, fourth and fifth years of employment); (iii) an option to purchase up to 100,000 shares of Avista stock at the market price as of July 1, 1998 (approx. $22.65 per share – vesting 1/4 each year after the first through fourth anniversaries with the Company); (iv) a base salary of $750,000 per year; (v) a bonus payment of up to 150% of his base salary; (vi) and a significant equity incentive compensation plan.\textsuperscript{2} The Employment Agreement specifically provided that if Matthews were terminated for cause during the five year term of the agreement (or if he resigned), he would receive none of these lucrative payments of cash and stock in the future, would not receive any of the stock options or restricted stock which had not yet vested, and would have to return a pro-rata share of the $1 million signing bonus.

\textsuperscript{1} Avista Corp. 1998 SEC Form 10-K, Exhibit 10(s), § 3.

\textsuperscript{2} Id. at §§ 4.1 – 5.3.
21. The WUTC made a specific finding that Matthews' total compensation (i.e., cash plus stock payments) was "unreasonably high." In particular, they found that the $1 million signing bonus was "excessive and unprecedented in Washington utility regulation."

22. At all times relevant hereto, defendant Jon E. Eliassen ("Eliassen") was Chief Financial Officer of the Company. Because of his position with the Company during the relevant period, defendant Eliassen had access to the material, adverse, non-public information about Avista's internal control structure, as well as the Company's finances, and had access to internal corporate documents (including the Company's operating plans, budgets and forecasts, and reports of actual operations compared thereto), conversations and communications with other corporate officers and employees, attendance at management and Board of Directors' meetings and committees thereof, and via reports and other information provided to him in connection therewith, and directly communicated with securities analysts regarding Avista's business and financial conditions.

23. The officer defendants identified above (collectively the "Individual Defendants"), because of their positions of control and authority as officers of the Company, were able to and did control the contents of the various quarterly and annual financial reports, SEC filings, press releases, and presentations and communications with securities analysts pertaining to the Company. Each Individual Defendant was provided with copies of Avista's press releases and SEC filings.

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4 Id. at 69.
alleged herein to be misleading prior to or shortly after their issuance and had the
ability and opportunity to prevent their issuance or to cause them to be corrected.

24. The Individual Defendants engaged in the scheme in order to conceal
Avista's speculation in risky derivative contracts in order to (i) protect and enhance
their executive positions and the substantial compensation paid to them by the
Company; and (ii) enhance the value of their personal Avista securities holdings and
options.

25. Each of the Individual Defendants either knew or with deliberate
recklessness disregarded the fact that the illegal acts and practices, and misleading
statements and omissions described herein would adversely affect the integrity of the
market for Avista common stock and would artificially inflate or maintain the prices
of those securities.

26. Each of the Individual Defendants, by acting as herein described, did so
knowingly or in such a deliberately reckless manner as to constitute a fraud and deceit
upon plaintiff and the members of the class that plaintiff seeks to represent.

IV. CLASS ACTION ALLEGATIONS

27. Plaintiff brings this case as a class action pursuant to Rule 23(a) and
(b)(3) of the Federal Rules of Civil Procedure on behalf of a class consisting of all
persons and entities who purchased Avista securities or sold put options for Avista
common stock during the Class Period (the "Class"), that is, during the period April
14, 2000 (the date of Avista's undisclosed entry into speculative derivative contracts)
through June 21, 2000 (the date on which Avista first publicly revealed the extent of
the financial impact of the losses related to the speculative contracts). Excluded from
the Class are the defendants herein; any subsidiaries or affiliates of Avista; the
officers and directors of Avista during the Class Period; members of the Individual
Defendants’ immediate families; any person, firm, trust, corporation, officer, director or any individual or entity in which any defendant has a controlling interest or which is related to, or affiliated with, any of the defendants; and the legal representatives, agents, affiliates, heirs, successors-in-interest or assigns of any such excluded party.

28. During the Class Period, millions of shares of common stock of Avista were traded on the New York Stock Exchange (the “NYSE”), an efficient and developed securities market. Thousands of brokers nationwide have immediate access to trading information about Avista through the NYSE. Within minutes of any transaction taking place, this system displays the most recent trades and prices.

29. The members of the Class are so numerous that joinder of all members is impracticable. Avista has more than 47 million shares of common stock outstanding. During the Class Period, millions of shares of Avista stock were purchased by hundreds or thousands of persons located throughout the United States. The exact number of Class members may be determined through appropriate discovery.

30. Plaintiff’s claims are typical of the claims of the members of the Class. Plaintiff and all members of the Class sustained damages as a result of defendants’ wrongful conduct complained of herein.

31. Plaintiff will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class action and securities litigation. Plaintiff has no interests that are adverse or antagonistic to, or in conflict with, the interests of the other members of the Class.

32. A class action is superior to other available methods for the fair and efficient adjudication of this controversy because, among other things, it would be impracticable and undesirable for all members of the Class to bring separate actions in various parts of the country. In addition, because the damages suffered by many individual Class members may be relatively small, the expense and burden of
individual litigation make it virtually impossible for Class members to seek redress individually for the wrongful conduct alleged herein.

33. The prosecution of separate actions by individual Class members also would create the risk of inconsistent and varying adjudications concerning the subject of this action, which adjudications could establish incompatible standards of conduct for defendants under the laws cited herein. Further, common questions of law and fact exist as to all members of the Class and predominate over any questions affecting solely individual members of the Class in that, at least by use of publicly filed reports, defendants have acted on grounds generally applicable to the entire Class. Among the questions of law and fact common to the Class are:

(a) whether the federal securities laws were violated by defendants’ acts as alleged herein;

(b) whether statements disseminated to the investing public and securities markets by the defendants omitted or misrepresented material facts concerning the Company’s speculation on future electricity prices and the state of the Company’s system of internal controls overseeing derivative transactions;

(c) whether defendants, to the extent required by the federal securities laws, acted with the requisite state of mind in omitting and/or misrepresenting material facts concerning the failure to disclose the financial impact that the risky derivative contracts could and would have on the Company’s financial results;

(d) whether the market price of Avista’s securities during the Class Period was artificially inflated or maintained due to the misrepresentations and/or non-disclosures concerning the speculative derivative contracts on the Company’s financial results; and

(e) whether the members of the Class have sustained damages and, if so, the appropriate measure thereof.
34. Plaintiff knows of no difficulty that will be encountered in the management of this litigation that would preclude its maintenance as a class action. The names and addresses of the record owners of Avista securities purchased during the Class Period are available from the Company or its transfer agent(s). Notice may be provided to such record owners via first class mail using techniques and a form of notice similar to those customarily used in class actions.

V. FACTUAL ALLEGATIONS

A. Background Information

1. Utilities Stocks in General

35. It is a basic premise of portfolio management that utilities companies are among the safest and most predictable stock investments. In fact, defendant Matthews himself disclosed how he had always described Avista Utilities as a "very stable" company with "minimal downside:"

Thanks to you, the interest in Avista's never been higher. This makes it all the more important today to come to help you understand how a difficult situation has occurred within our utility, which over the years we have said [Avista Utilities is] a very stable, efficient utility and one that has built its reputation over many years as a utility with a minimal downside.5

This is because utility stocks are the perfect embodiment of a "sure thing" for which no real business risk exists. A utility is typically a government-regulated monopoly that has a fixed supply of customers that have no other place to go for a product that is a basic necessity.

36. A regulated utility's (such as Avista Utilities) revenue streams are fixed by the state to provide a stable and dependable rate of return to the company's

5 June 21, 2000 Avista Conference Call Transcript, pp. 3-4.
shareholders. In establishing the utility’s allowable prices (known as the “rate base”),
the regulatory authority (in this state, the Washington Utilities and Transportation
Commission (“WUTC”)) takes into consideration the costs associated with generating
electricity as well as the company’s capital structure. The WUTC begins with the
costs of generating the electricity, then adds an amount to pay bondholders of the
company, and another premium designed to ensure a specified return to shareholders.
In Avista’s case, the WUTC allows them a return on equity of 11.16%.6

37. If the company can operate the utility in a reasonably efficient manner,
the shareholders are guaranteed a return in excess of 11%. The utility need not take
any business risks or market risk to achieve such returns. And the typical utility
shareholder is happy with such returns that expose them to very little risk.

2. Avista Corporation

38. Avista Corp. is a diversified corporation including a division that is a
regulated electric and natural gas utility. In addition to the regulated utility portion of
its business (Avista Utilities), the Company maintains other non-regulated
subsidiaries that are involved in other business opportunities. The Company’s
operations are organized into four lines of business: (i) Avista Utilities, (ii) Energy
Trading and Marketing, (iii) Information and Technology, and (iv) Pentzer and
Other.7

39. Within this diversified corporation, the Energy Trading and Marketing
line of business is pursued primarily by Avista Energy, an unregulated subsidiary of

6 Third Supplemental Order (Final Order), WUTC v. Avista, Docket No.
UE-991606, September 2000, p. 96.

the corporation.\textsuperscript{8} Avista Energy maintains a portfolio of its investments that it marks to fair market value on a daily basis (mark to market accounting).\textsuperscript{9} Avista Energy has extensive levels of internal controls designed to minimize the risks associated with commodities speculation, many of which it obtained in Avista’s acquisition of Vitol in 1999.\textsuperscript{10} These internal controls include a daily analysis of the risk of Avista Energy’s commodity portfolio utilizing a Value-at-Risk (VAR) model that measures potential losses at a given time interval.\textsuperscript{11} Avista Energy maintains its portfolio such that its average daily VAR is less than $1 million.\textsuperscript{12} To minimize its potential exposure to risky derivative products, Avista Energy’s strict controls include daily reporting of open positions, strict maximums on the allowable limits of commodity trading, a vice president of risk management with oversight authority on all trades, a compliance officer monitoring the daily trades and numerous other safeguards.\textsuperscript{13} To run this operation, Avista Energy employs numerous professionals that are experts in marketing and trading energy-related derivative products.

40. Importantly, Avista Utilities was not considered a part of the Company’s Trading and Marketing line of business, as demonstrated in its 1999 Form 10-K.\textsuperscript{14}

\begin{itemize}
\item \textsuperscript{8} Avista Corp. 1999 SEC Form 10-K, p. 24.
\item \textsuperscript{9} \textit{Id.} at 27.
\item \textsuperscript{10} Interview with a former employee of Avista Energy.
\item \textsuperscript{11} Avista Corp. 1999 SEC Form 10-K, p. 36.
\item \textsuperscript{12} \textit{Id.} at 36.
\item \textsuperscript{13} Interview; Avista Corp. Financial Risk Policy, pp. 4-5.
\item \textsuperscript{14} Avista Corp. 1999 SEC Form 10-K, p. 46.
\end{itemize}
That is because Avista Utilities lacked the financial ability of Avista Energy to trade derivatives in a speculative manner. Avista Utilities, as described below, enters into a small level of derivative contracts under certain, tightly controlled circumstances (i.e., hedging or resource optimization), but its personnel are experienced in hedging transactions, not speculative transactions. Because the Federal Regulatory Energy Commission ("FERC") has regulations prohibiting interaction between the regulated utility and the non-related energy trading business at Avista Energy, Avista Utilities could not draw upon the expertise of the trading department at Avista Energy.\textsuperscript{15} As admitted in sworn testimony before the WUTC by a Vice President of Avista Utilities, "Although the Resource Optimization Department does engage in some level of commercial trading transactions, it is not set up as a full-scale energy trading and marketing operation."\textsuperscript{16}

Accordingly, Avista Utilities, as described below, always held itself out to the market as the "stable" business with "minimal downside" that only used derivatives for hedging purposes.

B. Avista Utilities

41. Avista Utilities consists of the regulated utility operations that are responsible for retail electric and natural gas distribution, electric transmission services and electric generation and production. It is within the Avista Utilities

\textsuperscript{15} Testimony of Thomas Matthews, WUTC v. Avista, Docket No. UE-991606, March 27, 2000, TR 148-49.

\textsuperscript{16} Direct Testimony of Kelly Norwood, WUTC v. Avista, Docket No. UE-991606, p. 27.
division of Avista that the problems complained about by plaintiff exist, and this complaint focuses primarily on the misconduct within Avista Utilities.

42. **Avista Utilities provides electricity and natural gas distribution and transmission services in a 26,000-square mile area in eastern Washington and northern Idaho with a population of approximately 835,000.** It also provides natural gas distribution service in a 4,000-square mile area in northeast and southwest Oregon and in the South Lake Tahoe region of California, with the population in these areas approximating 500,000. At the end of 1999, retail electric service was supplied to approximately 309,000 customers in eastern Washington and northern Idaho; retail natural gas service was supplied to approximately 269,000 customers in parts of Washington, Idaho, Oregon and California.\(^1\)

1. **Misrepresentations Regarding Avista Utilities’ Declining Electric Generating Capacity That Exacerbated the Company’s “Short” Position on Power**

43. **During the years 1997 through 1999, Avista Utilities purchased between 65% and 66% of its electrical requirements from other generation sources, and generated the remainder itself.** For the portion that Avista Utilities generates itself, approximately 38% comes from thermal generation (i.e., coal, wood-waste or gas burning) and 62% from hydroelectric.

44. **The Centralia Coal Plant accounted for between 37% and 38% of Avista Utilities’ total thermal generation during the years 1997 through 1999.** This plant was very important to Avista Utilities’ ability to fulfill its obligations to its customers.

45. **On May 4, 2000, Avista Utilities formally contracted for the sale of its interest in the Centralia Coal Plant to TransAlta Corp.** Prior to that date, Avista’s share of the electrical generation from this plant was 175 MW. As part of the

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\(^1\) Avista Corp. 1999 SEC Form 10-K, p. 4.
purchase agreement, Avista entered into a long-term contract with TransAlta for the
purchase of 175 MW, but only beginning July 1, 2000 through December 31, 2003.
There was no provision for Avista’s purchase of any power from May 5, 2000
through July 1, 2000.

46. This left Avista with a major hole to fill. The 1999 Form 10-K filed with
the SEC on March 17, 2000, admitted that, should the sale be consummated, “Avista
Utilities will require additional generating capacity.” But the very next sentence
promised that “[i]f TransAlta becomes the new owner, it has agreed to replace Avista
Utilities’ lost output for three years through a purchase agreement.” This statement
was false and misleading because TransAlta only agreed to a purchase agreement
beginning in July of 2000. This meant Avista Utilities would have a large “short”
position between May and July of 2000 related to the loss of capacity from Centralia,
before this purchase agreement contract kicked in.

C. Avista Utilities Promised That it Would Enter Into Derivative
Transactions Only as a Hedge Against Market Fluctuations or Means to
Optimize Resources – Not For Speculation

47. As defendant Matthews himself maintained, Avista Utilities was sold to
the market as a “stable” company with “minimal downside.” One of the primary
reasons for this perceived safety was that Avista Utilities maintained, in numerous
places, including their annual reports, filings with regulatory commissions and in
sworn testimony before those regulators, that Avista Utilities did not participate in the
one area that could cause disaster at a regulated utility – speculating on future energy
prices using derivatives.

18 Avista Corp. 1999 SEC Form 10-K, p. 5.
19 June 21, 2000 Conference Call Transcript, p. 4.
1. Derivatives

48. Derivatives are financial instruments which "derive" their value from underlying assets such as electricity, interest rates, stock indexes or agricultural products, but whose performance does not change proportionately with the underlying asset. In fact, changes in the underlying asset's value often are magnified in the derivative's price. Accordingly, derivatives are often employed to alter the level of risk related to potential changes in prices for commodities. These uses can range from risk reduction or "hedging" techniques to outright speculation, as explained by the American Institute of Certified Public Accountants in their handbook Derivatives – Current Accounting and Auditing Literature:\(^{20}\):

Uses of derivatives to alter risks range from uses that help mitigate or control volatile risk exposures (activities that include the idea of taking defensive action against risk through hedging) to uses that increase exposures to risk and, by that, the potential rewards (the idea of offensive action, often considered as trading or speculation).

* * *

A Hedge is a defensive strategy. It is used to avoid or reduce risk by creating a relationship by which losses on certain positions ... are expected to be counterbalanced in whole or in part by gains on separate positions in another market.

Derivatives can be used for many purposes, from hedging strategies designed to minimize risk and lock in profitability to strategies calling for pure speculation, as highlighted by the Barings Bank disaster of several years ago. To maintain its

reputation as a “stable” company with “minimal downside,” in the words of defendant Matthews,\(^2\) Avista made the following disclosures providing that, unlike Barings Bank, Avista Utilities used derivatives only as a means of “hedging” or minimizing risk rather than speculation.

2. Assurances in Avista’s Annual Report

49. Avista’s annual report for the year ended December 31, 1999 on SEC Form 10-K, as signed by defendants Matthews and Eliassen and filed with the SEC on or about March 17, 2000, and in effect in the Securities Market during the Class Period, described the Company’s limited use of derivatives, but specifically maintained that these strategies would be used not for speculation, but to “manage the risks associated with market fluctuations in the price of electricity”:

**COMMODITY PRICE RISK**

Avista Utilities and Avista Energy are exposed to market fluctuations in the price and transportation costs of electric and natural gas commodities and, therefore, utilize derivative commodity instruments to hedge the impact of these fluctuations on their energy-related assets, liabilities, and other contractual arrangements. In addition, Avista Energy trades these instruments to take advantage of market opportunities. At times this may create a net open position in its portfolio that could result in material losses if prices do not move in the manner or direction anticipated. The Company and Avista Energy’s risk management program and policies are designed to manage the risks associated with market fluctuations in the price of electricity and natural gas commodities (see Note 4 of Notes to Financial Statements for additional information). (Emphasis added.)\(^2\)

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21 June 21, 2000 Conference Call Transcript, p. 4.

22 Avista Corp. 1999 SEC Form 10-K, p. 35.
This provision plainly states that while Avista Energy – an unregulated subsidiary of Avista Corp. – might engage in limited derivative trading under controlled circumstances to take advantage of “market opportunities.” Avista Utilities, by omission from this provision, was excluded from that possibility. As described in note 4 to the financial statements referenced by the above provision, Avista Utilities would only enter into such transactions as a means to “manage the risks associated with the price of electricity,” i.e., to hedge against losses from unforeseen price movements that would otherwise have a detrimental impact on Avista Utilities.23 The notes to the financial statements, specifically note 4 to which the above provision refers, places further limits on derivative trading by Avista Utilities, specifically providing that derivatives are not used for speculative purposes:

AVISTA UTILITIES

The Risk Management Committee has limited the types of commodity instruments Avista Utilities may trade to those related to electricity and natural gas commodities and those instruments are to be used for hedging price fluctuations associated with the management of resources. Commodity instruments are not generally held by Avista Utilities for speculative trading purposes.

* * *

At December 31, 1999 and 1998, the Company’s derivative commodity instruments outstanding were immaterial. (Emphasis added.)24

This provision could not be clearer that Avista Utilities only enters into derivative contracts for the purpose of hedging against future price movements.

23 Avista Corp. 1999 SEC Form 10-K, p. 52.

24 Id.
Avista Utilities specifically promised in this provision that derivatives would not be used for speculative trading purposes.

3. Public Disclosures in Avista Utilities' Risk Management Program

50. Avista Corporation’s Corporate Financial Risk Policy is a public document that was filed with the WUTC on or about February 8, 2000. The policies described in this document were implemented by Avista Corp. and its subsidiaries on June 24, 1999. This public document is referred to in the provisions cited above from the 1999 SEC Form 10-K, and provides more detail into the risk policies and procedures in place at Avista and Avista Utilities. According to Avista’s Corporate Financial Risk Policy, a derivative transaction can only be considered “hedging” if it meets all of the following four criteria:

(a) The item to be hedged exposes the Company to price risk.

(b) The hedging instrument reduces that exposure and is designated as a hedge at the time that it is entered.

(c) The significant characteristics and expected terms of the anticipated hedging instrument transaction are identified and linked to the exposure to be hedged. The significant characteristics and expected terms include the date of the transaction, the commodity involved and the quantity to be purchased or sold.

(d) It is probable that the anticipated transaction will occur. Sales of future production from the Company’s inventory or existing or proven physical or financial reserves are “anticipated transactions” that may be


26 Id. at cover letter.
considered “probable” to occur and are thus *hedges* under these guidelines.\(^{27}\)

51. The Company’s Corporate Financial Risk Policies further elaborated that all derivative transactions that did not meet these four criteria to be considered “hedging” activity would be considered speculation:

*Speculation* is defined as the entering into of a physical or financial transaction solely for profit purposes that result in an overall increase in risk. *Speculation* can be used to generate profits. These profits can be generated by buying or selling *forward, index* and *hedging instruments* to arbitrage profit opportunities. All transactions of *hedging* activities not meeting the above *hedging* definition shall be deemed *speculation*.\(^{28}\)

Under these definitions, which are commonly accepted and understood by the financial community, the defensive use of futures or options to “lock-in” a specific level of profits from sales of electricity, or to “lock-in” a specific purchase price in the future would be considered a risk-minimizing or “hedging” transaction. On the other hand, entering into derivative contracts that would increase exposure to market price changes would be considered a “speculative” transaction.

a. The Risk Management Program’s Ban on Speculation Using Derivatives By Avista Utilities

52. Avista Utilities trades some derivative products for limited purposes, and only through its Resource Optimization Group. Section Six of the Corporate Financial Risk Policies is entitled Avista Utilities’ Resource Optimization Risk Policy, and contains very specific provisions as to the types and levels of risk that could be undertaken by Avista Utilities, including further elaboration regarding

\(^{27}\) Avista Corp. Corporate Financial Risk Policy, pp. 9-10.

\(^{28}\) *Id.* at 10.
exactly what constitutes a transaction made “for the purpose of optimizing system resources.”

The primary focus of Resource Optimization is to acquire power resources on behalf of its customers, and to operate those resources, both owned and contracted, in a manner which optimizes the value of the resources to customers and shareholders. These activities include selling surplus at maximum value. This includes hedging transactions and other energy trading activities that occur as a direct result of the prudent management of resources and result in additional value to customers and shareholders. (Emphasis added.)

This policy plainly contemplates that Avista Utilities may “hedge” or enter into transactions for the purpose of allowing it to run its generation facilities more efficiently, but nothing in this policy statement addresses the use of the Resource Optimization program for speculative purposes.

53. This lack of approval for speculative use of derivatives is specifically delineated in Avista Utilities’ Resource Optimization Risk Policy’s “Limits of Risk” section, which lays out very specific ground rules related to the limits of risk acceptable to Avista Utilities, the products that are authorized, how trader performance is benchmarked, and what reporting is required. Most importantly, the risk optimization policy for Avista Utilities provided specifically that “Futures contracts shall be used only for hedging physical purchases and sales.”


30 Avista Corporate Financial Risk Policy, p. 58.
also sets maximum amounts of megawatts that the utility is allowed to be short, allowed to have in options or in futures.\textsuperscript{31}

54. According to Avista Utilities' Resource Optimization Risk Policy, "Futures Contracts" are tradable obligations to buy or sell electricity at a future date.\textsuperscript{32} This policy limited Avista Utilities from entering into futures contracts for any speculative purpose that was not strictly related to "locking in" a selling price of the utility's electrical generation:

Futures contracts can be used by Resource Optimization to fix prices or lock in a profit margin when marketing production. Exchange traded futures can be used to deliver or receive electricity at market hubs.\textsuperscript{33}

According to these criteria, Avista Utilities could not enter into futures contracts for speculative purposes. Transactions such as "selling the Mid-Columbia Index" when the Company is in a "short" position do not fit within these guidelines.

55. "Options Contracts" are another derivative tool that were contemplated by the Resource Optimization Risk Policy, but again, only as a defensive too, and not for speculation:

Option contracts will be utilized by Resource Optimization to provide a minimum floor price, lock-in a range of prices and/or provide a ceiling for prices.\textsuperscript{34}

According to these criteria, Avista Utilities could not enter into options contracts for speculative purposes.

\textsuperscript{31} Id. at 57-58.
\textsuperscript{32} Id. at 58.
\textsuperscript{33} Id.
\textsuperscript{34} Id. at 59.
56. In summary, Avista’s Risk Optimization Policy, which specifically includes and incorporates Avista Utilities’ Resource Optimization Risk Policy, expressly prohibit the use of futures contracts, options and other derivative transactions for the purpose of speculation. Any derivative contracts that do not fit with the four-pronged definition of a “hedging” contract is considered speculation.

4. Sworn Testimony Before WUTC

57. Defendant Matthews, in sworn testimony before the Washington Utilities and Transportation Commission (“WUTC”) on March 27, 2000, set forth examples of short-term arrangements with neighboring utilities that take advantage of the Company’s transmission system and delivery point options and that entail only minimal risk.

As an example would be the utility does a lot of exchange of power activities across the state between Puget and Montana Power and others. Oftentimes, they’ll come up to be certain situations where because of the trade going on inside a utility, Puget will tell Avista Utilities, “we’ve got an extra block of power, can you move it for us?” And they’ll do that. That communication is forbidden with Avista Energy [an unregulated subsidiary of Avista Corp.].

Oftentimes in their work they do with Avista – I mean, with Bonneville Power Authority, a lot of the trades that go on across the Northwest are done between Avista and Bonneville, from a utilities standpoint. And Bonneville might have surface power. They will use the utility issues to move circuit power. A lot of that sort of communication is forbidden to go outside of the utility.

So it’s just the opportunities that come up with system optimization between the multiple utilities stays within utility. Avista Energy’s [an unregulated subsidiary of
Avista Corp.'s activities generally dealing with real third-party buying and selling outside utility operations.35

Again, Avista, through its CEO, maintained that it only traded power for “system optimization” reasons, and that any speculation that could occur was only undertaken by Avista Energy.

58. Thus, the risk management provisions of the Form 10-K, in conjunction with Avista Utilities’ Resource Optimization Risk Policy and the sworn testimony of defendant Matthews, plainly provide that Avista Utilities only enters into derivative contracts for the purposes of (i) hedging, or (ii) “optimizing system resources” — meaning that if Avista had excess generating capacity, and the generating equipment’s efficiency was “optimized” at a certain level for maximum efficiency, Avista would sell the excess electricity generated to optimize the efficiency of the plant. Likewise, if the Company’s energy requirements for its customers were in excess of its generation capacity, or would be more inexpensively fulfilled by purchasing power from other utilities, that is what the Company would do. Nowhere was it ever disclosed to investors that Avista Utilities could or would gamble on the future price of electricity.

D. Avista Utilities’ System of Internal Controls

59. In combination with the strict policies regulating the use of derivatives at Avista Utilities, the market was comforted by the Company’s repeated assertions that it had strict controls in place that did not allow unauthorized speculation with derivative products. Avista’s 1999 Form 10-K filed with the SEC on March 17, 2000, described Avista’s system of internal controls that were in place to limit the risk of trading in derivatives:

35 March 27, 2000 testimony of Thomas Matthews, TR-148-49.
ENERGY COMMODITY TRADING

The Company's energy-related businesses are exposed to risks relating to changes in certain commodity prices and counterparty performance. In order to manage the various risks relating to these exposures, Avista Utilities utilizes electric, natural gas and related derivative commodity instruments, such as forwards, futures, swaps and options, and Avista Energy engages in the trading of such instruments. Avista Utilities and Avista Energy have adopted policies and procedures to manage the risks inherent in these activities and have established a comprehensive Risk Management Committee, separate from the units that create such risk exposure and overseen by the Audit and Finance Committee of the Company's Board of Directors, to monitor compliance with the Company's risk management policies and procedures.\(^{36}\)

This provision discloses that a Trading Risk Management Committee (the "Risk Management Committee") - a committee separate from all business units and reporting directly to the board of directors - would oversee the level of risk undertaken by Avista Utilities. The notes to the financial statements in the 1999 Form 10-K filed with the SEC on March 17, 2000, further elaborated on the system of internal controls:

**AVISTA UTILITIES**

Avista Utilities protects itself against price fluctuations on electric energy and natural gas by limiting the aggregate level of net open positions which are exposed to market price changes and through the use of electric, natural gas and related derivative commodity instruments for hedging purposes. The net open position is actively managed with strict policies designed to limit the exposure to market risk.

\(^{36}\) Avista Corp. 1999 Form 10-K, p. 52.
and which require daily and weekly reporting to management of potential financial exposure.\textsuperscript{37}

61. This daily and weekly reporting to management provided assurances that one "rogue trader" – acting alone – would surely be discovered within a day of any trades being entered. This strict oversight is important to minimizing the risks of any unauthorized or non-complying derivative position.

62. The Corporate Financial Risk Policy described in greater detail the system of internal control that was identified in the Form 10-K filed with the SEC on March 17, 2000:

The Trading Risk Management Committee must approve any transaction beyond the limits described in the... Avista Utility Resource Optimization Policy and monitor all transactions associated with the commodity or services price derivatives or financial derivatives.\textsuperscript{38}

63. The Corporate Financial Risk Policy further established the position of Resource Optimization Risk Manager – overseeing all trading activity at Avista Utilities. The Risk Manager is required to report any transaction beyond the limits described in the Resource Optimization Risk Policy or as directed by the Trading Risk Management Committee at Corporate Risk Control.\textsuperscript{39}

64. Strict reporting requirements were also established for any trades made by Avista Utilities. On a daily basis, a report is distributed to traders, the Department Manager and the Risk Manager that includes: (i) a description of the changes in financial position of all transactions (following a mandatory daily reconciliation of all

\textsuperscript{37} Id.

\textsuperscript{38} Avista Corporate Financial Risk Policy, p. 11.

\textsuperscript{39} Avista Corporate Financial Risk Policy, p. 61
individual transactions to the recorded book of transactions); and (ii) a Value-at-Risk calculation on the entire portfolio measuring the worst potential portfolio loss under certain assumptions. On a weekly basis, a report is distributed to the Trading Risk Management Committee that includes: (i) a report of daily positions; and (ii) a description of all new activity since the last report. Monthly, a financial performance summary report is distributed to the Trading Risk Management Committee and other appropriate parties.  

65. These reporting requirements ensure that any trading activity that occurs within Avista Utilities is brought to management’s attention within a day, and within a week to the independent committee reporting directly to the board.

66. These representations explicitly state that Avista Utilities has strict internal controls in place that ensure that Avista Utilities’ risk management policies are being followed. Shareholders and the market could, according to this provision, be confident that no risky trading can occur without the knowledge and consent of Avista’s management and board of directors.

67. With these multiple and unambiguous assurances that Avista Utilities does not speculate on energy price movements and that it has adequate controls in place to be certain that unauthorized speculation could not take place, the market had no fear that Avista was engaging in rampant speculation. Avista’s share price was strong during early 2000, exceeding $41.00 per share in late March. On April 13, 2000, the day before the Class Period begins, Avista shares closed trading at more than $39.00 per share.

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40 Avista Corporate Financial Risk Policy, pp. 60-61.
E. Avista Utilities Gambles on the Future Price of Electricity

68. By at least April 14, 2000, despite their knowledge that the shortfall of generation capacity caused by the sale of the Centralia Power Plant would further exacerbate their “short” position, Avista Utilities entered into numerous large derivative contracts for delivery of power to certain clients through October of 2000 at fixed prices. These obligations were far in excess of Avista Utilities’ ability to generate the electricity, and Avista Utilities was required to pay for this power at the then-prevailing mid-Columbia index price.

69. Based in part upon interviews with news sources who followed these events and in part upon the testimony of Avista executives cited herein, plaintiff has learned that Avista entered into a large number of transactions on or about April 14, 2000 (the April 14, 2000 Derivative Contracts”). These contracts were a combination of buying options and selling futures (“selling the mid-Columbia index”) that essentially obligated Avista Utilities to provide vast amounts of electricity in the future at fixed prices, but forced the Company to purchase that electricity at future market prices. This subjected Avista Utilities to substantial market price risk – the risk that the value of the electricity would be substantially higher at the time the contract had to be performed.41

70. Under these circumstances, if the company could obtain power at a lower price in the future, it would enjoy significant profits from this gamble. On the other hand, if the Company were forced to pay an even higher price than it would obtain in

41 Interview with reporter from a major news publication that followed this story closely. This reporter informed us that based upon his conversations with Avista employees, the April 14, 2000 Derivative transactions were a combination of purchasing options and “selling the Mid-Columbia index.”
selling the power, it would lose on the transaction. Although the transactions and
financial derivative products employed were complex, their results are easy to
understand. The April 14, 2000 Derivative Contracts were plain and simply pure
speculation on what the price of electricity would do. It was essentially no different
than putting your money on “black” on a roulette wheel. If the ball falls on “black”
(or power prices go down), the Company is a big winner. If the ball lands on “red”
(or power prices rise) – the Company loses. And the bets were so big, that a
significant upward move in electricity price would cripple the Company. But
shareholders and the market were never told of this massive bet that was being made
with their money. And they would not be told until June 21, 2000 – well after the bet
had lost, resulting in great losses to their shares in the Company.

71. As subsequently admitted by Kelly Norwood (the current vice president
and General Manager of Energy Resources for Avista Utilities) in sworn testimony
before the WUTC, these types of trading activities were “speculative in nature. [were]
not related to the operation of the Company’s system resources or in serving retail
load.”

F. The Speculative Contracts Put the Company in an Undisclosed “Double
Whammy”

72. Washington is one of a number of states that do not have a general
“power adjustment clause” in the regulated utility rate base that would allow a
regulated utility to request “emergency” rate increases when power prices increase

dramatically.\textsuperscript{43} Instead, Washington operates under a formula whereby power costs are recovered by the utility on a long-range average cost basis. Individual yearly fluctuations are not taken into account in establishing a rate base, and any requests for an adjustment must meet strict guidelines, including a cost-of-capital reduction that reduces the shareholders' return.\textsuperscript{44}

73. Thus, a regulated utility that purchases power for resale to its customers in Washington is subject to the risk of dramatic short-term price increases in electricity that it must purchase wholesale to distribute to its customers at relatively fixed rates.\textsuperscript{45}

74. By being a regulated utility that did not generate enough electricity to cover all of its distribution needs, Avista already faced risk of rapidly rising wholesale prices. Any speculation with derivatives that the price of electricity would not go up only served to intensify this already existing risk. In essence, the risk of dramatically increasing electricity prices in the short term would be felt twice by Avista Utilities, once with respect to the derivative contracts betting that prices would go down, and again when power would have to be purchased wholesale at higher rates and sold to customers at rates that would not be dramatically adjusted. This


\textsuperscript{44} Third Supplemental Order (Final Order), WUTC v. Avista, Docket No. UE-991606, September 2000, p. 49-52

\textsuperscript{45} Id.
“double-whammy” made Avista Utilities’ speculation on lower electricity prices that much more central to the Company’s operations.

G. Avista Utilities’ Massive Bet on Future Electricity Prices Backfires

75. From April 14, 2000 (the date of the April 14, 2000 Derivative Contracts) through early May, the price of electricity rose. For example, the Dow Jones mid-Columbia Index of the cost of firm power indicates that the price of peak power rose from $22.69 per MWH on April 14, 2000 to $44.75 per MWH on May 7, 2000. It rose to $51.26 per MWH by May 18 and to $170.85 per MWH on May 24, 2000. While this price increase was occurring, Avista Utilities was locked into massive levels of derivatives promising to supply electricity at a low fixed price. Without the generating capacity to cover these contracts, Avista Utilities was forced to buy it on the open market from other vendors at prices that were typically in the $40-$50 per megawatt range by May 12, 2000.

76. This rise in electric prices was detrimental to Avista Utilities’ speculative transactions. Although Avista shareholders and the market were kept in the dark about these losses and the risky position that Avista Utilities was involved with, the losses were piling up throughout the Class Period. One of Avista’s ex-managers would later disclose, as reported by the September 29, 2000 SPOKESMAN-REVIEW, that the Company had quickly realized that the April 14, 2000 Derivative Contracts had already cost the Company $10 to $20 million, and that the Company was aware that its speculative positions put it at risk to lose even more. But rather than alert the market to the fact that these large losses had already occurred, and that the Company was still gambling on lower electric prices in violation of its stated policies, the Company instead decided to keep its investors in the dark – apparently hoping instead to “double down” on the bet and recoup the money they had already
lost. If they could recoup these losses, the market need never know about the losses that had occurred.

H. Public Filings Made During the Class Period Ignore The Company's Massive Gamble in Future Electric Prices

77. Avista's Form 10-Q for the period ended March 31, 2000 was filed with the SEC on May 12, 2000. This document was signed by defendant Eliassen. The Form 10-Q made specific representations dealing with the risks of energy trading and Avista's management of those risks:

ENERGY TRADING BUSINESS

The participants in the wholesale energy market are public utility companies and, increasingly, power and natural gas marketers which may or may not be affiliated with public utility companies or other entities. The participants in this market trade not only electricity and natural gas as commodities but also derivative commodity instruments such as futures, forwards, swaps, options and other instruments. This market is largely unregulated and most transactions are conducted on an "over-the-counter" basis, there being no central clearing mechanism (except in the case of specific instruments traded on the commodity exchanges). Power marketers, whether or not affiliated with other entities, generally do not own production facilities and are not subject to net capital or other requirements of any regulatory agency.

Avista Utilities and Avista Energy are subject to the various risks inherent in commodity trading including, particularly, market risk and credit risk.

Market risk is, in general, the risk of fluctuation in the market price of the commodity being traded and is influenced primarily by supply (in the case of electricity, adequacy of generating reserve margins, as well as scheduled and unscheduled outages of generating facilities

46 Form 10-Q for quarter ended March 31, 2000 (filed May 12, 2000).
or disruptions to transmission facilities) and demand (caused by extreme variations in the weather and other factors. Market risk includes the risk of fluctuation in the market price of associated derivative commodity instruments. All market risk is influenced to the extent that the performance or non-performance by market participants of their contractual obligations and commitments affect the supply of, or demand for, the commodity.

RISK MANAGEMENT

The risk management process established by the Company is designed to measure both quantitative and qualitative risk in the business. Avista Utilities and Avista Energy have adopted policies and procedures to manage the risks inherent in their business and have established a comprehensive Risk Management Committee, separate from the units that create the risk exposure and overseen by the Audit and Finance Committee of the Company’s Board of Directors, to monitor compliance with the Company’s risk management policies and procedures on a regular basis. Nonetheless, adverse changes in interest rates, commodity prices and foreign currency exchange rates may result in losses in earnings, cash flow and/or fair values.

Interest Rate Risk The Company’s market risks related to interest rates have not changed materially from those reported in the 1999 Form 10-K.

Commodity Price Risk. The Company’s market risks related to commodity prices have not changed materially from those reported in the 1999 Form 10-K. The following Value-at-Risk (VAR) information has been updated for the current period. At March 31, 2000, Avista Energy’s estimated potential one-day unfavorable impact on gross margin was $1.2 million, as measured by VAR, related to its commodity trading and marketing business. The average daily VAR for the first quarter of 2000 was $0.9 million.

(Emphasis added.)

78. This Form 10-Q was materially false and misleading when made because it did not disclose that Avista had entered into widespread speculation on the future
cost of electricity. Rather, this Form 10-Q provided that “[t]he Company’s market
risks related to commodity prices have not changed materially from those reported in
the 1999 Form 10-K (where the level of derivative’s was said to be “immaterial”).
No mention was made of the large bets made by the Company through the Derivative
Contracts, or the fact that it was apparent that such bets were already losing. This
disclosure just compounded the earlier assertions made in the 1999 Form 10-K that
derivative contracts would be used as hedging devices rather than speculative tools.

79. Given the Company’s massive short position in electricity and the
knowledge that it had already lost substantial money with the potential to lose much
more, the Form 10-Q was false and misleading.

80. This Form 10-Q also contained false and misleading information about
the impact of the sale of the Centralia plant on the Company’s short position in
electricity:

Avista Utilities will require additional generating capacity,
so TransAlta has agreed to replace Avista Utilities’ lost
output for three years through a purchase agreement.47

This statement was materially false and misleading in that it portrayed the loss
of generating capacity as not affecting the Company’s short position in electricity for
the next three years. In reality, this purchase agreement was not effective until July 1,
2001, leaving the Company short an additional 175MW that it would have to obtain
at market prices – thereby incurring large and undisclosed market risk from May 5,

I. The Trading Losses Continue to Mount

81. Unfortunately for Avista and its shareholders, the trading losses from the April 14, 2000 Derivative Contracts and other bets continued to mount. From May 12, 2000 through May 25, 2000, the price of electricity climbed from the high $40's to the mid-$60’s, causing massive losses to Avista Utilities’ derivative positions, including the April 14, 2000 Derivative Contracts. From May 25, 2000 (the date that defendant Matthews has admitted he was aware of the April 14, 2000 Derivative Contracts) through June 21, 2000, the price of electricity had soared to more than $100 per megawatt – and to almost $400 per megawatt on June 14, 2000.

82. Even if senior management had not been aware of the April 14, 2000 Derivative Contracts immediately (which could or should not happen under Avista’s system of internal controls as described above), they admitted to having such knowledge no later than May 25, 2000, but did not inform the market of the massive undisclosed gamble existing in violation of Avista Utilities’ previously stated risk policies. Instead, apparently hoping to “double-down” and recover these losses by continuing their secret bet, defendants engaged in a cover-up of the problem. If the losses could be recovered by continuing the bet the problem would not have to be reported on the quarterly financial statements, and all of the defendants would escape scrutiny of their culpability. But as any gambler knows, chasing your losses to get back to even is usually a foolish and dangerous strategy – and electricity price gambling proved to be no exception to this basic axiom.

48 These prices are reported in the Dow Jones Mid-Columbia Index, as reported by the WALL STREET JOURNAL.

83. By June 21, 2000, with the price of electricity (which Avista Utilities had to buy) still well in excess of the price at which Avista Utilities was obligated to sell under the April 14, 2000 Derivative Contracts, the losses had become devastating. This was an unmitigated disaster to Avista Utilities’ derivative gamble – costing the company and its shareholders a total of more than $140 million in losses during the second quarter – between 60% and 66% of which ($84 million to $93 million) were specifically attributable to the improper derivative transactions.  

84. By June 21, 2000, it was clear that these trading losses were so staggering to Avista Utilities that there was no conceivable way that their continued “doubling down” or pressing their losing bets could ever recoup this $140 million before the end of the quarter on June 30, 2000, when these massive trading losses would have to be recognized in its quarterly financial statements. Avista and the Individual Defendants would then be held accountable by the market for the undisclosed gambling on electricity prices that eliminated all of Avista’s profits for the entire year.

85. On June 21, 2000, Avista issued a press release giving the first hint of the massive losses from the previously undisclosed speculation, and the press release and a conference call with analysts by defendant Matthews laid the groundwork for the scapegoat “rogue trader” excuse. Roger Scholten (“Scholten”), a former trader at Avista Utilities had committed suicide on April 15, 2000 at his home in Idaho  

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would be blamed by an Avista press release and by Defendant Matthews in a conference call for the derivative speculation problem.

J. The Truth About the Speculative Contracts is Partially Disclosed to the Market

86. On June 21, 2000, Avista disclosed over the PR NEWSWIRE (and simultaneously filed a Form 8-K with the SEC containing this press release) that severe financial problems had resulted from the Company's speculation on future energy prices:

Avista Corp. (NYSE: AVA) today announced that unprecedented sustained peaks in electric energy prices throughout the Pacific Northwest and California in May and June, compounded by a wholesale short position exceeding management guidelines, are contributing to significant losses for the second quarter at the company's regulated utility operation.

Avista Utilities is expected to spend approximately 25 percent more for purchased power this year because of sustained price peaks, causing it to lose more than $90 million in gross margin in the second quarter due to additional power costs. If current pricing levels sustain through year-end, additional potential losses of at least $50 million in gross margin could occur.

* * *

In addition, an Avista Utilities energy trader entered into excessive levels of short-term, fixed-price contracts for wholesale sales for delivery of power through October 2000, without making matching purchases at the time. Avista Utilities was forced to buy additional power at prices significantly higher than the selling prices to cover those contracts.

52 Avista Corp. Form 8-K, dated June 21, 2000; June 21, 2000 PR NEWSWIRE.
The volume of short-term wholesale sales exceeded management guidelines. When senior management became aware of the short positions, it was determined, in light of projected market conditions based on historical pricing data, that the most prudent course of action was to avoid the high costs of immediate action to offset the effect of these positions. Instead, the utility began to gradually diminish its exposure. (Emphasis added.)

87. Thus, senior management admitted that it was well aware of the speculative positions in Derivative Contracts taken by the Company, but decided to continue to speculate on energy prices into the future. And defendants further decided to conceal these massive risks from the shareholders and the market. As described above, their gamble backfired, causing massive losses to the Company—losses that wiped out the Company’s entire net income for both the second quarter and fiscal year 2000.

88. The Company further elaborated on its large “short” position that was the result of the Derivative Contracts, and confirmed that it “didn’t lock in rates for May and June, because open market prices were low at the time.” In a classic understatement, the Company admitted, “in hindsight, not covering this position was a mistake.” Indeed it was, and this “mistake” cost Avista’s shareholders, who were not aware of these massive gambles being taken by the Company on future energy prices, more than $800 million in market capitalization loss.

1. The June 21, 2000 Conference Call With Defendants Matthews and Eliassen

89. On June 21, 2000 at 9:30 a.m. CDT, defendants Matthews and Eliassen had a conference call with analysts to describe the trading losses suffered by the

53 June 21, 2000 PR NEWswire.
defendant Matthews admitted that he "just plain blew it in the utility:"

[A] difficult situation has occurred within our utility, which over the years we have said to be a very stable, efficient utility and one that has built its reputation over many years as a utility with a minimal downside. In our press release this morning, we have outlined to you the extent of the losses that we project through the year-end for the mistakes and miscalculations we made in the utility.  

* * *

Now some of these are due to the impact of higher power prices, the likes of which we have never seen in the Northwest. But some of it's also due to business judgment, that in hindsight was just dead wrong. And to be as candid as I can with you, we just plain blew it in the utility. That's my ultimate responsibility. 

* * *

Also, our utility operated its short-term wholesale commodity marketing business beyond our management guidelines. This may have been okay, all right in any other pricing environment because what occurred would normally have created only a $10 million to $15 million problem for the utility. But in these volatile power markets we've seen this spring and for this year, it has created a $100 million problem for this wholesale commodity marketing. 

* * *

Now, we're in the process of mitigating all these issue's we've talked about. And we believe the largest hit is going

54 June 21, 2000 Conference Call Transcript, pp. 3-4.
55 June 21, 2000 Conference Call Transcript, p. 4.
56 June 21, 2000 Conference Call Transcript, p. 6.
to occur here in the current quarter, the second quarter. But the wind-down process will take several more months and it will impact somewhat the third and fourth quarters. But the improper wholesale marketing contracts are due at the end of October, and that problem goes away.\(^{57}\)

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But during the past several months a trader within the utility went beyond management guidelines and made what in hindsight turned out to be some pretty lousy power deals and took improper risk in doing so in that physical utility business. When we in senior management became aware of this in May, of the impact of these activities, forward prices continued to escalate and we made the conscious decision at the time to move slowly to unwind these contracts.\(^{58}\)

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But to prevent a continuation of any situation within the utility on the wholesale marketing side, we are now eliminating totally those short-term wholesale commodity sales within Avista Utilities going forward. This means we will not conduct wholesale marketing that is not directly related to optimizing our own utility resources. A trader and marketer who was involved with those trades is no longer with the Company, and we’ll be shutting down that part of the business.\(^{59}\)

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As to the utility business, we made serious mistakes this year in terms of how we operated and some of the decisions

\(^{57}\) June 21, 2000 Conference Call Transcript, p. 7.

\(^{58}\) June 21, 2000 Conference Call Transcript, p. 8.

\(^{59}\) June 21, 2000 Conference Call Transcript, p. 9.
we made. But after we became aware of those in early May, I think the solutions are well in hand. (Emphasis added.)

Thus, defendant Matthews had admitted that the derivative trading was in excess of the Utilities' Resource Optimization Risk Policy, and that they had eliminated such unauthorized trading for the future. Shockingly, Matthews also admitted that senior management was aware of the problem by "early May," but continued to cover it up until the disclosure made on June 21, 2000.

90. Defendant Matthews responded to a question from an analyst at First Boston by describing the circumstances that surrounded the April 14, 2000 Derivative Contracts:

But also we had a trader that not only was told to cover the shortage that we had and buy, he actually went short. And he went short by a factor of four more than anybody had ever been supposed to be and left totally naked in index positions. And so the whole thing, literally there in a period of time in April, after which time we discovered it and the trader left and the trader is actually no longer living.61

Defendant Matthews admitted that the trading was in excess of Avista Utilities' Resource Optimization Risk Policy by a factor of four. This passage also disclosed the fact that the Company was "totally naked" in index positions (meaning that there was no cap on or protections from the losses the Company could suffer if the index should rise dramatically). Although not a peep was ever mentioned to an unsuspecting market prior to this disclosure, this was an incredibly risky position, particularly relative to the Utilities' declining generating capacity.

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60 June 21, 2000 Conference Call Transcript, p. 12.

91. In response to a question about the loss of generating capacity by the sale of the Centralia plant, Matthews admitted that the Company was aware of the “short” position this caused, and had contracted for replacement power beginning July 1, 2000, but had made the “conscious decision” to remain uncovered in May and June\textsuperscript{62} – thus exposing the Company to undisclosed market risk and exacerbating the problem caused by the improper derivative trades.

92. A subsequent question was addressed to defendant Eliassen regarding the Derivative Contracts and the purported “rogue trader:”

S. GOLDBERG: When you talk about this rogue trader, which we’ve all heard about in the past. Can you just tell us what controls are now in place so this doesn’t happen again?

J. ELIASSEN: We had controls in place at the time. The issue with him is that the positions were discovered. Trading management ordered the positions taken off and in a very short period of time, positions were put back on and then found after he left. All this happened within a couple of days and over a weekend. But the controls were there.

We have to separate that piece, though, from then what happened in the market because the conscious decision was made to get out of those positions over a period of time rather than immediately when they were found. In hindsight that was a mistake.\textsuperscript{63}

Indeed it was. And defendant Eliassen had also admitted that Avista Utilities had made the “conscious decision” to keep the bets going (while failing to correct their earlier statements that such bets would not be made by Avista Utilities to their

\textsuperscript{62} June 21, 2000 Conference Call Transcript, p. 20.

\textsuperscript{63} June 21, 2000 Conference Call Transcript, pp. 48-49.
shareholders and the market). Thus also necessarily admitting that the conscious
decision to keep the bets covered-up was also made.

93. Subsequent questions of defendant Matthews confirmed the fact
management was aware of the April 14, 2000 Derivative Contracts well before the
June 21, 2000 disclosure but the existence of these speculative contracts was kept
hidden from the market. Defendant Matthews admitted that the “rogue trades” were
known by the Company by at least April 19, 2000:

MATTHEWS: The unfortunate thing, the control of that
individual, was it was literally on a Friday when all this
happened and he did not do what he was told. When it was
uncovered the next Monday, Tuesday, Wednesday, [Since
Scholten died on April 15, those dates were no later than
April 17, 18 or 19] by that time literally is when you see the
charts that we gave you. Prices there the first week of May
started exploding. 64

S. GOLDBERG: Is there any recourse against this
individual and, Tom, when did you find out?

MATTHEWS: I found out on May 25. 65

S. GOLDBERG: When is that in relation to when this
happened?

MATTHEWS: It is two and a half weeks after they
discovered it. 66

Thus, defendant Matthews admitted that he personally was aware of the April
14, 2000 Derivative Contracts by at least May 25, 2000, and that other senior

64 June 21, 2000 Conference Call Transcript, pp. 49-50.
65 June 21, 2000 Conference Call Transcript, p. 50.
66 Id.
company officials were aware of the problem at least two and one half weeks earlier—
on or about May 7, 2000, and that other company employees were aware by at least
April 19, 2000. This conclusively demonstrates that during the Class Period,
defendant Matthews and other senior management were well aware of the massive
level of risky derivative speculation on the price of electricity, but chose to cover-up
this vital information so as not to inform the market or the Company’s shareholders of
these already large losses and massive future risks.

94. The market immediately rejected Avista’s attempted “rogue trader”
excuse as unbelievable and inconsistent with market prices, observations of other
traders and the Company’s previously disclosed risk management program.

95. On June 23, 2000, DOW JONES ENERGY SERVICE issued a stinging
criticism of Avista’s excuses for its gambling losses entitled “Avista’s Dead-Guy
Excuse Doesn’t Add Up.”67 This article painstakingly demonstrated why this massive
problem could not possibly have been the undiscovered work of a “rogue trader” as
had been maintained by Avista senior management:

Avista Corp. (AVA) executives have given a number of
excuses the past two years for the company’s poor
performance. But they hit a new low Wednesday when they
primarily blamed a now-deceased trader for losses that have
negated all profits for the company in the second quarter
and probably for the year – an explanation that market
prices, traders and logic all contradict.

*   *   *

According to Matthews and Eliassen, the situation
materialized as follows. Scholten sold Northwest power
short into a market with rising prices. The trading manager

67 Power Points: Avista’s Dead Guy Excuse Doesn’t Add Up, DOW JONES
caught the trades and ordered Scholten to unwind them. At first, Scholten complied. But then he abruptly reversed course and, unbeknownst to his managers, magnified Avista’s exposure on the day before he died. Managers began to cover the new short position the next week, when they realized what Scholten had done. But they did so too gradually, costing the company even more money, Avista said. Pressed by analysts, Eliassen said 60% of the company’s $140 million in real and expected losses were the result of Scholten’s trades.

96. This reporter quotes defendants Matthews and Eliassen as admitting that management knew of the April 14, 2000 Derivative Contracts within a week of their being entered into. As shown above, the Company never disclosed their existence until June 21, 2000. Although it was convenient for the Company to blame the actions of one dead ex-employee for its troubles, this DOW JONES reporter continued by demonstrating that the vast majority of the losses could not possibly have been suffered prior to management’s knowledge and assent to the short positions because the power prices’ movement over that time period simply did not support management’s assertions:

Market prices at the time don’t support Matthews’ and Eliassen’s account. According to Dow Jones Newswire’s market report on the Western U.S. forward electricity market on April 14, May contracts for delivery to the mid-Columbia rose 25 cents to $25.75 a megawatt-hour. If Scholten had sold a large amount of May power that day, prices undoubtedly would have come down.

97. The article continued to demonstrate that the massive losses caused by the short position could not have been the work of Scholten acting alone without management’s consent or knowledge by quoting several traders that were familiar with Scholten and his trading during that time period:

Matthews and Eliassen’s explanation of how they managed the crisis defies logic. If Scholten’s initial short position
was so bad that he was ordered to get out of it immediately, as Matthews and Eliassen said, why did the company take so long to get out of Scholten’s new short position when they were in full control? Was it because forward prices got too expensive between Friday and Monday? Not likely. May and June mid-Columbia prices remained in the middle to high $20’s for two weeks, before moving markedly higher May 1. They’ve yet to come down. Avista didn’t liquidate most of the “rogue” positions, including the months-old sale of some call options for the third quarter, until the past few weeks, Avista executives said. Yet Scholten, who died more than two months ago, is supposed to be responsible for 60% of the damage.

Thomas McAndrews, who has traded Western U.S. electricity for years, and is well respected by his colleagues, was one of many traders appalled by Avista’s spin. “If Matthews had an adequate risk management system in place – like Wall Street assumes he has – this would have been caught two months ago,” McAndrews said. “If the losses were caught two months ago, they became upper management’s responsibility, not Roger’s.” “You have to draw one of two conclusions. Either their risk management system is completely insufficient, or it was management’s position,” he said.

98. Mr. McAndrews summarized the issues in this case perfectly. Avista had maintained in its Form 10-K for the year ended December 31, 1999 that it had adequate controls to “manage the risks associated with market fluctuations in the price of electricity and natural gas commodities.” Further, Avista Utilities’ Resource Optimization Risk Policy laid out, with great specificity, the risk management controls in place regarding these types of trades. If a single trader had been able to enter into enough derivative contracts to wipe out Avista Utilities’ income for the entire year of 2000 (and four times in excess of this maximum, as admitted by defendant Matthews), the reported risk management system was plainly insufficient, and materially different than how it was disclosed to the market. On the other hand,
if the risk management polices worked, management was fully aware of the
undisclosed gamble on electricity prices, and failed to inform the market. Either way,
Avista management made a material misrepresentation to its shareholders and the
market that cost its unsuspecting shareholders hundreds of millions of dollars.

99. On June 23, 2000, THE ASSOCIATED PRESS reported that Avista had
decided not to pass these trading losses on to their customers, but would force
shareholders to absorb the losses. The paper quoted Steve Becker, a spokesman for
Avista, as stating that “we are not going to ask our customers to pay the costs of
trading losses.” Given that Washington state law precludes Avista’s recovery for
these gambling losses, as described above, this was not a particularly magnanimous
gesture, but highlighted the fact that it was the shareholders all along that were
unwittingly forced to back this high-stakes gamble made by Avista without the
shareholders’ knowledge.68

100. The market was outraged by this late disclosure of the massive losses
from the Derivative Contracts and other short positions in energy taken by the
Company in its high-stakes gamble with investors’ money. As a result, shares of
Avista, which had closed trading on April 6, 2000 – the day before the Class Period
begins – at $37-11/16 per share, closed trading on June 21, 2000 at $19 per share – a
loss of almost 50%, resulting in a market capitalization loss of more than $800
million to Avista’s shareholders.

68 Utility Subsidiary loses $90 million, THE ASSOCIATED PRESS STATE & LOCAL
VI. SUBSEQUENT EVENTS DEMONSTRATE THE MISREPRESENTATIONS MADE BY THE DEFENDANTS AND THEIR KNOWLEDGE OR DELIBERATE RECKLESSNESS IN MAKING THE MISREPRESENTATIONS

101. On July 13, 2000, defendant Eliassen testified under oath before the WUTC about the speculative nature of the trading losses suffered by Avista Utilities:

The bottom line on this is the things that have hurt the Company in May and June, by and large excess wholesale transactions that had nothing to do with retail loads, and those aren’t things we will do again. 69

Defendant Eliassen’s sworn testimony highlights the fact that Avista Utilities’ trading activity was not done to “optimize system resources” or for hedging purposes — and was, in fact, outright gambling on the future price of electricity. In response to a question by Commissioner Hemstad regarding whether or not the trades were made “to meet retail load requirements,” defendant Eliassen admitted that “some were in excess of that amount.” 70

102. On July 26, 2000, Avista announced its second quarter results over the PR NEWSWIRE. 71 These disastrous results were even worse than the dire predictions made by the Company on June 21, 2000. For the second quarter, Avista Utilities recognized a shocking loss of $1.33 per share.


70 Id. at 1907.

71 Avista Corp. Reports Second Quarter Earnings; Utility Signs Advisory Services Agreement With Williams Companies; Non-Utility Businesses Continue to Grow, PR NEWSWIRE, July 26, 2000.
103. In this same July 25, 2000 press release, Avista, apparently realizing that its risk management policies were hopelessly deficient and far inferior to those policies it had previously disclosed to the public, announced that it had hired Williams Energy Marketing & Trading to advise Avista Utilities on “risk management, risk analysis and resource optimization issues.” Avista also made an admission that its derivatives gamble on electricity prices was far outside of its previously disclosed guidelines:

Avista Utilities is eliminating its short-term utility wholesale commodity sales and trading activities that are not related to optimizing system resources used for retail sales.

This disclosure was shocking in light of the previous disclosures in Avista’s Form 10-K that Avista Utilities was only trading “primarily for the purpose of optimizing system resources.”72 Thus, the Company made a public disclosure that, although it had been caught red-handed speculating on future energy prices, it would not do it again, ignoring the fact that it had already promised not to do so in its 1999 Form 10-K, among other documents.

104. In sworn testimony to the WUTC, Kelly Norwood (a current Avista Utilities Vice-President) later admitted on cross-examination that the speculative trades undertaken by Avista Utilities were wholly unrelated to “optimizing” system resources:73

And you may have seen the recent press release that the company issued stating that the company is no longer going

72 SEC Form 10-K at p. 4.

to enter into wholesale transactions that are unrelated to operating [the] system for our customers.

Again, an Avista Utilities officer admitted that, despite its repeated assurances that it would not engage in such conduct, its April 14, 2000 through June 21, 2000 trading was speculative, and wholly unrelated to the “optimization of system resources.”

105. On July 27, 2000, THE SPOKESMAN-REVIEW elaborated on the troubles at Avista Utilities, and defendant Matthews' spin on hiring Williams to oversee Avista Utilities' risk management program: 

Matthews said Avista has hired Williams Energy Marketing & Trading Co. to advise Avista Utilities on managing risk and optimizing use of its resources. That agreement runs from Aug. 1 to June 30, 2002. Matthews said others could be negotiated later. "They will provide us protection and stability," he said. Terms were not disclosed.

* * *

Matthews said Avista executives, by retaining Williams, restructuring Avista Utilities electricity trading, and pursuing rate relief, have corrected the company's problems. (Emphasis added.)

Thus, defendant Matthews had again admitted that the massive unexpected trading losses in Avista Utilities and/or its utter lack of internal controls that allowed the speculation to take place, was a "problem" that needed "correction," and that Avista Utilities, despite assurances to the contrary in the Company's Form 10-K, did not have the ability to adequately perform, manage or oversee Avista Utilities' derivative program to make sure it operated within publicly disclosed guidelines.

106. On July 31, 2000, ELECTRIC UTILITY WEEK reported that, as a result of the financial disaster at the Company, Moody’s Investors Service had downgraded Avista senior secured debt from A3 to Baa1, and was keeping it under review for another downgrade.

107. On or about August 14, 2000, Avista filed with the SEC its quarterly report on Form 10-Q for the quarter ended June 30, 2000. This Form 10-Q confirmed the horrible financial news finally disclosed by the Company on July 26, 2000, as described above. This Form 10-Q was signed by defendant Eliassen. This quarterly report also discussed the trading disaster that had occurred within Avista Utilities, including admitting that the trades were “outside normal operating guidelines:”

Based on the Company’s views of streamflows, historic market prices and energy availability in the second quarter of 2000, the Company entered into contracts and sold call options for fixed-price power for delivery through the remainder of the year, without making matching purchases at the same time, and also made certain short-term sales at fixed prices which were offset by purchases at prices indexed to the market price at the time of delivery. Certain of these positions were outside normal operating guidelines. Avista Utilities was therefore required to buy additional power not only to meet its obligations to its retail and long-term wholesale customers, as described above, but also to cover its wholesale short positions. The process was impeded by the rapid escalation of market prices and lack of liquidity in the power markets. These purchases were made at fixed prices significantly higher than the related selling prices and at index, which settled at unprecedented levels in June. The pricing of these purchases caused substantially

75 Net Loss Greater Than Predicted; Moody’s Cuts Ratings and May Do So Again, ELECTRIC UTILITY WEEK, July 31, 2000.

76 Avista Corp. June 30, 2000 Form 10-Q.
all of Avista Utilities’ loss for the second quarter. (Emphasis added.)

This was as admission that the trades were outside Avista Utilities’ Resource Optimization Risk Policy, as identified above. The Form 10-Q described how the short position was further exacerbated by the loss of the generating capacity from the Centralia plant:

Avista Utilities’ short position was compounded by the May 5 sale of its interest in the Centralia plant, which reduced its system capacity by 175 megawatts. As part of the Centralia sale, Avista Utilities entered into a favorably priced three-year contract to purchase 175 megawatts from the Centralia plant beginning in July 2000. Based on historical trends and the Company’s views on power prices and availability of power for May and June at the time of the sale, Avista Utilities did not seek to replace the Centralia capacity for the months of May and June with firm commitments. (Emphasis added.)

It was this massive short position, caused by the Company’s derivative gambling in conjunction with its loss of generating capacity that caused the massive losses to the Company in the second quarter.

108. On August 23, 2000, Avista issued a press release over the PR NEWSWIRE announcing the firing or “resignation” of several executives that were key to the risk management activities of Avista Utilities. Specifically, Edward Turner (President of Avista Utilities), Patrick Damiano (Director of Wholesale Marketing and Trading for Avista Utilities) and Mary Lou Myers (Director of Finance for Avista Utilities). Thus, the three Avista Utilities’ executives with oversight responsibility of

78 Id.
the debacle that caused such massive losses to the Company were let go from the Company.

109. A copy of the August 23, 2000 press released was also filed with the SEC on this same date as an attachment to its Form 8-K. This Form 8-K was signed by defendant Eliassen.

110. On August 24, 2000, THE SPOKESMAN-REVIEW commented on the previous day’s “management changes.”

Several Avista Utilities executives have resigned, four months after a fiasco in wholesale electricity trading cost the company more than $100 million.

The departures of President Edward Turner, Patrick Damiano and Mary Lou Myers were announced Wednesday by Tom Matthews, chairman of Avista Corp., the utility subsidiary's parent.

The announcement did not link the departures to the trading losses, but Damiano was director of wholesale marketing and trading. Myers handled financial accounting for the utility.

In April, an energy trader for the utility made several deals that obligated the company to deliver power at preset prices over the next several months. Avista Utilities did not have enough electricity to fulfill those contracts, which meant the company had to purchase power.

When the nature and extent of the trades were discovered, managers decided to liquidate those contracts slowly,

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expecting that electricity prices would decline and the trades could be covered with little or no loss to the company.

Instead, prices soared, and in June, the company said it expected to lose $90 million as a result of the trading activity. The damage swelled to $126 million by the end of the second quarter as the cost of buying electricity to meet customer requirements continued to climb.

The subsequent plunge in Avista stock dropped the company’s market capitalization by almost half compared with levels in early April. Several shareholder lawsuits followed. (Emphasis added.)

Thus, the newspaper again outlined that Avista was well aware of this improper speculation that violated stated company policies by early April, but kept this massive gamble hidden from shareholders and the market until late June – when the damage had already been done.

111. On September 8, 2000, the Puget Sound Business Journal quoted an industry expert as directly implicating defendant Matthews in the trading disaster:

The company’s springtime energy-trading gamble “was the most important operating decision made all year,” said Bob McCullough, principal at Portland-based consulting firm McCullough Research. McCullough advises several area utilities on power purchase strategies. “Certainly the CEO had to be involved in that discussion. If he was involved then I think the board will have no choice but to let him go, and if he wasn’t involved then maybe he should explain why he wasn’t involved in making the most important operating decision of the year,” McCullough said.

* * *

The company initially blamed the debacle on Richard Scholten, a veteran energy trader who committed suicide in his Post Falls, Idaho, home on Saturday, April 21. [date

Industry watcher McCullough said he was skeptical of that theory. “This would be the single largest financial decision of the year,” McCullough said. “This wasn’t the work of a single rogue trader, this was a fundamental gamble that didn’t work out, and very clearly they continued to gamble.”

This shows that an industry expert agreed that it was not possible for the energy trades to have been performed by a “rogue trader” without management’s knowledge or approval. The industry expert confirmed that to a regulated utility – particularly one with a net power need above its generating capacity – the power purchasing and risk management program was so vital and central to the Company’s operations that upper management would – by necessity – be aware of any problems with it. This opinion does not conflict with the Company’s assertion in its 1999 Form 10-K that its internal control system would keep management and the board of directors informed in great detail regarding Avista Utilities’ derivative trading.

112. On September 18, 2000, the SEATTLE POST-INTELLIGENCER outlined the history of the Company’s lies regarding responsibility for the trading debacle, and described how Avista had suffered great credibility problems resulting from hiding its derivative losses, and then attempting to blame them on a deceased former employee:83

Companies make mistakes, misread markets, make errors of timing - it happens. A company's credibility suffers when it builds a record of such missteps. It also erodes its credibility if it misleads the public about how those mistakes occurred. And Avista has a credibility problem.

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And, indeed, that credibility problem has been cited by a market analyst following the Company, but was probably most completely summarized by Avista’s own hometown newspaper more than three months after the initial disclosure of the trading losses.

113. On September 29, 2000, THE SPOKESMAN-REVIEW summarized the many problems that Avista Utilities had encountered in its derivative speculation, including its initial excuses, its loss of credibility with investors, and the fact that the company was no longer sticking to its “rogue trader” story regarding the losses:

In June, Avista Corp. executives blamed much of their $140 million in real and projected energy trading losses on Roger Scholten, a senior energy trader who killed himself in mid-April.

But after a barrage of skeptical questions from Wall Street, the company has backed off what one Dow Jones columnist calls “Avista’s Dead Guy Excuse.”

“We sincerely regret the association of any individual employee with the losses. They are solely the responsibility of management,” Avista spokesman Steve Becker says.

* * *

In a conference call with Wall Street analysts in June, Avista blamed 60 percent of the $90 million it had already lost and an additional $50 million it expected to lose by October on Scholten’s trades.

“A trader within the utility went beyond management guidelines and made what in hindsight turned out to be some pretty lousy power deals,” Avista CEO Tom Matthews told the analysts.

The financial press quickly rejected Matthews’ explanation.

Avista “hit a new low” when the company blamed the dead trader for their unusual losses, wrote Mark Golden of Dow Jones Newswires. It was an explanation “that market prices, traders and logic all contradict,” he wrote.

Avista’s decision to blame Scholten was cowardly, say two former Avista managers who have recently left the company for other jobs. They both asked not to be named in this story. “If Roger did improper trades, management should have known. If they didn’t know, that’s even worse,” says one of the managers.

Several energy traders dispute claims that Scholten made big “forward” trades for May and June in the weeks before his death that committed Avista to selling power without having the electricity to back up the trades.

Another former Avista manager says the company simply decided to let Scholten's trades ride in hopes wholesale market prices would fall.

“After Roger died, they said, ‘We could cover this and lose $10 to $20 million, or ride it out and cover when the prices drop.’ Only they didn’t drop,” the ex-manager says.

Avista dropped its “rogue trader” theory – a term coined by the press – before its required quarterly financial report was filed in late June with the Securities and Exchange Commission.

In September, Avista announced the resignation of three managers, including Patrick Damiano, the director of wholesale marketing and trading who was Scholten’s supervisor.

This summary hit most of the key points of this scandal and cover-up, including the fact that the Company was aware of the April 14, 2000 Derivative Contracts right after they were made, but chose to continue the bet in a misguided attempt to recover the $10 – $20 million in losses that were already incurred.
114. Apparently, these massive trading losses and falling credibility took its
toll on defendant Matthews. On October 20, 2000, THE SPOKESMAN-REVIEW reported
that defendant Matthews had been replaced as CEO.\(^8^5\)

115. This October 20, 2000 SPOKESMAN-REVIEW article also quoted an Avista
Energy (another subsidiary of Avista Corp.) founder as maintaining that the
Company’s recent troubles were primarily the result of Avista’s management being
deceptive with the market and its own shareholders:

The shareholder lawsuits are a reaction to Avista’s lack of
candor about the big trading losses, said Steven Fischer, an
Avista Energy founder who is now in Portland with
TransAlta, a Canadian energy company. Fischer worked for
WWP [the former name of Avista] for most of his career.

“In the good old days at WWP, even when you messed up,
you fessed up. The class action lawsuits are hitting on a
weakness – the company’s new tendency toward spin
control,” Fischer said.

116. On November 14, 2000, the ASSOCIATED PRESS\(^8^6\) reported that defendant
Matthews had also resigned as chairman of the board of directors of Avista Corp.: 

Facing a federal investigation and lawsuits by shareholders,
former Chief Executive Officer Tom Matthews has resigned
as chairman of the board of Avista Corp. Matthews
resigned last month after two years as CEO, and had said he
planned to stay as chairman through the end of the year. He
resigned from the board on Friday.

In addition to the generous salary and perks racked up during his tenure,
defendant Matthews left with a generous severance package, while the shareholders

\(^8^5\) Avista Replaces its Chief Executive; Matthews Resigns After Year of Turmoil;

he purported to serve were left with more than $800 million in market capitalization loss from Avista’s class period highs.

VII. UNDISCLOSED ADVERSE INFORMATION

117. The true status of Avista’s operations and massive losses caused by its speculation in risky derivatives were concealed by defendants, which operated to artificially inflate or maintain the market price of Avista stock during the Class Period. Each of the releases, SEC filings and other statements particularized herein was false and misleading and misrepresented and/or failed to disclose the following information:

(a) That Avista was engaging in speculative Derivative Contracts for the delivery of electricity at fixed prices far into the future, thereby incurring a substantial commodity price risk should the price of electricity rise;

(b) that such Derivative Contracts exposed the Company to potentially infinite losses;

(c) that the Company was not using derivatives to minimize risk but was engaged in speculative contracts;

(d) that Avista did not have the generating capacity or other ability to make delivery on its Derivative Contracts without incurring substantial market risk regarding the price of electricity;

(e) that the defendants were consciously or with deliberate recklessness failing to monitor the Company’s “traders” that were given full contracting authority to enter into the Derivative Contracts;

(f) that the Company did not have in place a proper system for monitoring and correcting the Company’s exposure to risk related to Derivative Contracts;
(g) that the generating capacity lost by the sale of the Centralia plant would cause an uncovered “short” position that would remain uncovered during May and June of 2000;

(h) that senior management was aware of the derivative contracts and the fact Avista was short of electricity but decided to gamble on the price of electricity thereby exposing Avista to substantial losses; and

(i) that as a result of the foregoing, Avista was not a “stable” investment but a highly risky one, so risky that its entire profits for the year were at issue.

118. As a result of the foregoing, there was no reasonable basis in fact for defendants’ statements that: (i) derivative contracts were only used by Avista Utilities to “optimize system resources,” or to “manage the risks associated with market fluctuations in the price of electricity and natural gas” and that Commodity instruments are not generally held by Avista Utilities for speculative trading purposes; (ii) that futures contracts were used only for hedging purposes; and (iii) the Company’s “net open position is actively managed with strict policies designed to limit the exposure to market risk and which require daily reporting to management of potential financial exposure.” The adverse facts set forth above were inconsistent with and seriously undermined those statements such that defendants had no reasonable basis to believe them and, in fact, did not believe them or were deliberately reckless in believing them.

VIII. STATUTORY SAFE HARBOR

119. The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to the allegedly false statements pleaded in this Complaint, as the statutory safe harbor does not apply to the defendants’
misrepresentations of currently existing or historical facts, including defendants’
dissemination of false statements regarding Avista Utilities’ risk management policies
and systems of internal control.

COUNT I
(Against All Defendants For Violations
of Section 10(B) of the Exchange Act
and Rule 10B-5 Promulgated Thereunder)

120. Plaintiff incorporates by reference and realleges the preceding
paragraphs as though fully set forth herein. This Count is asserted against all
defendants.

121. During the Class Period, defendants, directly and indirectly, by use of
means and instrumentalities of interstate commerce and/or the mails, engaged in a
plan and course of conduct, pursuant to which each of them knowingly or with
deliberate recklessness engaged in acts, transactions, practices, and courses of
business that operated as a fraud and deceit upon plaintiff and the other members of
the Class; made various untrue statements of material fact and failed to state material
facts necessary in order to make the statements made, in light of the circumstances
under which they were made, not misleading; and employed devices and artifices to
defraud in connection with the purchase and sale of securities, which were intended
to and, throughout the Class Period, did: (i) deceive the investing public, including
plaintiff and the other Class members regarding, among other things, the existence,
extent and speculative nature of forward sales contracts and other derivative
instruments for energy and the effect such derivatives could have upon the Company;
(ii) artificially inflate and maintain the market price of Avista securities; and
(iii) cause plaintiff and other members of the Class to purchase Avista securities at
artificially inflated prices.
1. **The Actionable Misstatements and Omissions**

122. Pursuant to the aforesaid plan and course of conduct, defendants participated, directly and indirectly, in the preparation and/or issuance of the statements and documents referred to above. Each of the Individual Defendants participated directly in the wrongs complained of herein. By reason of their senior positions as executive officers and/or directors, as well as their close personal working relationships, each of the Individual Defendants was a “controlling person” of Avista, within the meaning of § 20(a) of the Exchange Act, and had the power and influence, and exercised the same, to cause the Company to engage in the unlawful conduct complained of herein. The Individual Defendants were able to, and did, directly or indirectly, in whole or material part, control the content of Avista’s public financial reports, filings with the SEC, and public statements. Each Individual Defendant was provided, for his approval or otherwise, with copies of Avista’s reports, filings, releases, and statements herein alleged to have been materially false and misleading prior to or shortly after their issuance by the Company, and had the ability and opportunity to prevent their issuance or to cause them to be corrected.

123. As an officer and/or director of a publicly-held company, the common stock of which was and is registered pursuant to the federal securities laws, each Individual Defendant had a duty to disseminate timely, accurate, truthful, and complete information, and a duty to disseminate on behalf of the Company timely, accurate, truthful, and complete financial statements so that the market price of Avista common stock would be based on truthful, accurate and complete information. As hereinafter alleged, each Individual Defendant violated these specific duties and obligations.
124. Said statements and documents were materially false and misleading in
that, among other things, they misrepresented the status of Avista’s risk management
program in at least the following respects:

(a) Contrary to the representations made that Avista was a “very
stable, efficient utility and one that has built its reputation over many years as a utility
with a minimal downside,” defendants had engaged in speculative trading, when
combined with a short in its power supply, exposed the company to a substantial
downside that materialized and remained hidden throughout the Class Period;

(b) Defendants represented that as part of its sale of its interest in
Centralia, it had entered into a long-term contract for the purchase of power from
Centralia; however, they omitted from this disclosure the fact that Avista had no
commitment for such power leaving a large hole in its supply which, when combined
with the speculative trades, created enormous risk for investors;

(c) Contrary to their public assertion in their 1999 Form 10-K that the
Company’s risk management program and policies are designed to “manage the risks
associated with market fluctuations in the price of electricity and natural gas
commodities,” future contracts were used to speculate on the future costs of
electricity;

(d) Contrary to their public assertion in their Form 10-K that
commodity instruments are generally not held by Avista Utilities for speculative
trading purposes; Avista Utilities had in fact engaged in speculative trading;

(e) Contrary to sworn testimony before the WUTC that Avista traded
power solely for optimization purposes, Avista had been engaging in speculative
transactions as detailed above;

87 June 21, 2000, Avista Conference Call Transcript, pp. 3-4.
(f) Contrary to representations in the 1999 Form 10-K that its "net open position is actively managed with strict policies designed to limit the exposure to market risk," Avista had incurred excessive or substantial market risk;

(g) Contrary to representations in the Form 10-Q filed on May 12, 2000, the Company’s market risks had changed materially from those reported in the 10-K.

(h) Contrary to their public assertion in their 1999 Form 10-K that the "open position" of derivatives was "actively managed with strict policies designed to limit the exposure to market risk," these derivative contracts were used for vast and reckless speculation on the future prices of electricity;

(i) While the defendants portrayed the Company’s exposure to changes in the price of electricity as minimal, by at least April 14, 2000, the Company had exposed itself to massive amounts of derivative contracts for the sale of electricity at fixed prices, without making corresponding purchases or at least hedging against dramatic price increases. The Company failed to disclose this vital information to its shareholders until June 21, 2000; and

(j) Defendants failed to disclose that the sale of the Centralia plant would not, as previously asserted, be offset by a fixed-price contract to purchase the same amount of electricity for a three-year period. Rather, that replacement contract would not be effective between May and July of 2000, subjecting the Company to a massive short position and market price risk.

2. Defendants acted with scienter

125. At all relevant times, Avista and the Individual Defendants had actual knowledge that the statements and documents complained of herein were materially false and misleading as set forth herein and intended to deceive plaintiff and the other
members of the Class. In the alternative, those defendants acted with deliberate
reckless disregard for the truth in that they failed or refused to ascertain and disclose
such facts as would have revealed the materially false and misleading nature of the
statements and documents complained of herein, although such facts were readily
available to defendants. Said facts and omissions of defendants were committed
willfully or with deliberate reckless disregard for the truth. In addition, Avista and
the Individual Defendants knew or with deliberate recklessness disregarded that
material facts were being misrepresented or omitted as alleged herein.

126. Information showing that the defendants acted knowingly or with
reckless disregard for the truth is peculiarly within defendants’ knowledge and
control. As senior corporate officers of Avista, the Individual Defendants had
knowledge of the details of the Company’s financial affairs and results. Plaintiff,
who purchased Avista common stock on the open market, does not have knowledge
of the details of the Company’s internal corporate affairs. However, the following
facts, among others, indicate a strong inference that Avista and the Individual
Defendants acted with scienter by being aware of the nature and extent of the
improper derivative transactions without publicly disclosing either the existence or
extent of the massive “short” position to which the derivatives exposed the Company:

(a) The nature and size of the April 14, 2000 Derivative Contracts
made them so important and critical to Avista’s core operations that knowledge of the
improper transactions by the defendants can be inferred;

(b) Avista Utilities’ risk management policies established daily and
weekly reporting requirements of all open positions to management, demonstrating
that management must have been aware of these trades within one day or one week of
being entered into or were acting in reckless disregard of the representations they
made that such controls were in place;
(c) defendant Matthews admitted in a June 21, 2000 conference call with analysts that the improper derivative trading on April 14, 2000 was "uncovered
the next Monday, Tuesday, Wednesday. [Since Scholten died on April 15, he must have meant April 17, 18 or 19 – at the latest]"

(d) defendant Matthews admitted on a June 21, 2000 conference call that other senior management was aware of the derivative transactions by at least early May, and that Matthews himself knew by at least May 25, 2000, but Avista chose to neither hedge them nor disclose the serious risks posed by these contracts to shareholders or the market for almost a month;

(e) a former manager at Avista disclosed to the SPOKESMAN-REVIEW that the Company was aware of the April 14, 2000 Derivative Contracts early in the Class Period when they had only caused $10 to $20 million in losses, but chose to cover up their existence and continue the gamble without informing the market;

(f) defendant Eliassen admitted that Avista made the "conscious decision" to reverse the improper derivative trades "over a period of time," rather than right away. Never during the time this "conscious decision" was being implemented did Avista disclose either this strategy or the large outstanding short position;

(g) defendant Matthews admitted that Avista had made a "conscious decision" to remain uncovered and "short" in the months of May and June for the generation capacity lost due to the sale of the Centralia plant. This "conscious decision" was not disclosed to the market until the June 21, 2000 conference call;

(h) defendant Matthews had a powerful incentive to do whatever was necessary to keep this condition a secret in order to avoid, or at least delay being terminated for cause by the Company in order to protect his "unreasonably high"
annual compensation and to allow his restricted stock and options awards to vest, and
to keep from having to repay a pro-rata share of the $1 million back to the Company.

3. **Defendants’ fraudulent misconduct damages plaintiff and the Class**

127. As a result of Avista’s and the Individual Defendants’ fraudulent conduct as alleged herein, the prices at which Avista common stock were initially sold and purchased on the secondary market were artificially inflated throughout the Class Period. At the time that plaintiff and the other members of the Class purchased Avista common stock, the true value of such common stock was substantially lower than the prices paid by plaintiff and the other members of the Class. The market price of Avista common stock declined nearly 50% from $37-11/16 immediately prior to the Class Period to $19 per share on June 21, 2000. In ignorance of the materially false and misleading nature of the statements and documents complained of herein, as well as of the adverse, undisclosed information known to defendants, plaintiff and the other members of the Class relied, to their damage, on such statements and documents, and/or on the integrity of the offering and market prices of Avista common stock in purchasing such common stock at artificially inflated prices during the Class Period. Had plaintiff and the other members of the Class known the truth, they would not have taken such action.

128. At all relevant times, the misrepresentations and omissions particularized in this Complaint directly or proximately caused or were a substantial contributing cause of the damages sustained by plaintiff and the other members of the Class. The misstatements and omissions complained of herein created in the market an unrealistically positive assessment of Avista, as well as of its financial condition and ability to continue as a going concern, causing Avista common stock to be overvalued and artificially inflated at all relevant times. Defendants’ false portrayal, during the
Class Period, of the Company’s operations and prospects, as well as of Avista’s financial condition, resulted in purchases of Avista common stock by plaintiff and by the other members of the Class at artificially inflated prices measured by the difference between the market prices and the actual value of such common stock at the time of purchase, thus causing the damages complained of herein.

129. In addition, at the time Avista common stock was issued, such common stock was actively traded on the NYSE. As a result, the market for Avista common stock was well-developed, and the price at which such common stock was initially offered, as well as the prices at which it traded thereafter, necessarily reflected the material misrepresentations and omissions complained of herein.

130. As a direct and proximate result of defendants’ aforesaid wrongful conduct during the Class Period, plaintiff and the other members of the Class have suffered substantial damages in connection with their purchases of Avista common stock.

131. By virtue of the foregoing, each defendant has violated § 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

COUNT II
(Against the Individual Defendants for Violations of Section 20(a) of the Exchange Act)

132. Plaintiff incorporates by reference and realleges the preceding paragraphs as though fully set forth herein. This Count is asserted against Individual Defendants.

133. Throughout the Class Period, each of the Individual Defendants, by reason of their executive positions or position as Chairman of the Board, and as the owners, directly and/or indirectly of their shares of the Company’s common stock, had the power and influence, and exercised the same, to cause the Company to
engage in the unlawful acts, conduct, and practices complained of herein. As a result, at the time of the wrongs alleged herein, the Individual Defendants were “controlling persons” of the Company within the meaning of § 20(a) of the Exchange Act.

Pursuant to § 20(a) of the Exchange Act, by reason of the foregoing, each of the Individual Defendants is liable to the same extent as is Avista for the Company’s aforesaid violations of § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. As a direct and proximate result of said defendants’ wrongful conduct during the Class Period, plaintiff and the other members of the Class have suffered substantial damages in connection with their purchases of Avista common stock.

WHEREFORE, plaintiff and the Class pray for judgment as follows:

A. Declaring this action to be a proper class action pursuant to Rules 23(a) and 23(b)(3) of the Federal Rules of Civil Procedure on behalf of the Class defined herein;

B. Awarding plaintiff and the members of the Class compensatory damages;

C. Awarding plaintiff and the members of the Class pre-judgment and post-judgment interest, as well as their reasonable attorneys’ fees, expert witness fees and other costs;

D. Awarding extraordinary, equitable and/or injunctive relief as permitted by law, equity and the federal statutory provisions sued hereunder, pursuant to Rules 64 and 65 and any appropriate state law remedies, including attaching, impounding, imposing a constructive trust on or otherwise restricting the proceeds of the Individual Defendants’ open-market sales in the hands of defendants to assure that the Class has an effective remedy; and

E. Awarding such other relief as this Court may deem just and proper.
IX. JURY DEMAND

Plaintiff demands a trial by jury.

DATED: February 12, 2001

HAGENS BERMAN LLP

By

Steve W. Berman, WSBA #12536
Karl P. Barth, WSBA #22780
1301 Fifth Avenue, Suite 2900
Seattle, WA 98101
(206) 623-7292

Randi D. Bandman
Michael R. Reese
MILBERG WEISS BERSHAD HYNES
& LERACH, LLP
100 Pine Street, Suite 2600
San Francisco, CA 94111
(415) 288-4545

Paul J. Geller
CAULEY & GELLER, LLP
1 Boca Place, Suite 421A
2255 Glades Rd.
Boca Raton, FL 33431
(561) 750-3000

Richard D. Kranich
LAW OFFICES OF RICHARD D.
KRANICH
120 Broadway
Suite 1016
New York, NY 10271-0074
(212) 608-8965

Attorneys for Lead Plaintiff
The Hackett Group
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing First Amended and Consolidated Class Action Complaint for Violations of the Federal Securities Laws has been provided to the following parties in the manner indicated:

Via Overnight Mail, for delivery on 2/13/01:
Donald G. Stone
Paine Hamblen Coffin Brooke & Miller LLP
717 West Sprague Avenue, Suite 1200
Spokane, WA 99201-3505

Via Hand Delivery on 2/12/01:
Evan L. Schwab
Curt Roy Hineline
Dorsey & Whitney LLP
U.S. Bank Centre
1420 Fifth Avenue, Suite 3400
Seattle, WA 98101

Dated this 12th day of February, 2001.

Dawn Van Diest