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March 27, 2015

Via Electronic Mail

Steven V. King
Executive Director and Secretary
Washington Utilities & Transportation Commission
1300 S. Evergreen Park Drive S. W.
P.O. Box 47250
Olympia, Washington 98504-7250

Re: Docket No. U-150040 - Comments of Avista Utilities on *"Investigation of possible ratemaking mechanisms to address utility earnings attrition"*

Dear Mr. King,

Avista Corporation dba Avista Utilities (Avista or Company) submits the following comments in accordance with the Washington Utilities and Transportation Commission's (Commission) Notice of Opportunity to Submit Written Comments (Notice) issued in Docket No. U-150040.

BACKGROUND

On November 25, 2014, the Commission entered its Final Order in Avista Corporation's 2014 general rate proceeding.[1] In that order, the Commission directed Commission Staff to open

[1] *Utilities & Transp. Comm'n v. Avista Corp.,* Dockets UE-140188 and UG-140189, Order 05 (November 25, 2014).

an investigatory docket for the purpose of convening a forum to address attrition,[2] citing a clear consensus among the settling parties regarding the need for a formalized discussion of attrition along with other possible ratemaking mechanisms that may address the effects of attrition on earnings.[3] The Commission further stated that it expects the forum to be inclusive, open to participation by not only the parties in the proceeding under Dockets UE-140188 and UG-140189, but also the broader community of Commission-regulated utility companies and interested consumer groups.[4]

To understand better the causes of utility earnings attrition and possible ratemaking mechanisms to address them, the Commission has scheduled a workshop as a recessed open meeting on Thursday, April 16, 2015. The Commission requested that investor-owned electric and natural gas utilities in the state, and other interested persons, submit written comments to the Commission by Friday, March 27, 2015. Avista appreciates the opportunity to provide the following comments related to the questions identified by the Commission in its Notice.

AVISTA COMMENTS

1) **Your organization's perspective on the cause(s) of utility earnings attrition, e.g., high inflation, aggressive capital investment in infrastructure, low/no load growth.**

Avista Response:

The term "attrition" is typically used to refer to the erosion of a company's rate of return over time when the historical test period relationship in revenues, expenses and rate base accepted by the Commission in a rate case does not hold during future years. The cause of that attrition, therefore, can be caused by any of the above items, or a combination of the items, e.g., high inflation, increased capital investment in infrastructure, low/no load growth, etc., causing costs to grow faster than sales.

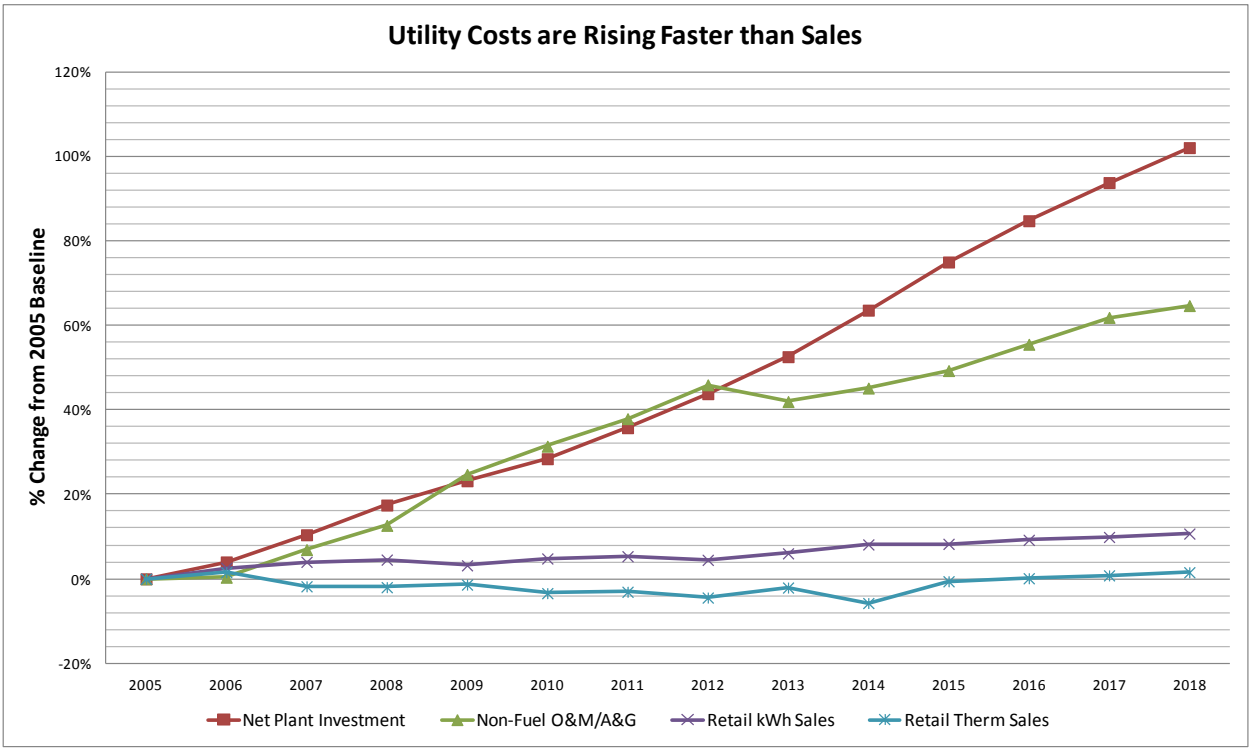
[2] *Id.*, at ¶ 51.

[3] *Id.*, at ¶ 50.

[4] *Id.*, at ¶ 51.

For Avista, the increase in its overall costs and the need to file annual rate cases over the last few years, has been, and continues to be, driven primarily by two major factors: 1) the continuing need to replace and upgrade facilities and technology, and 2) low revenue growth.

The chart below shows the year-over-year actual percentage changes in net plant investment, non-fuel O&M and A&G expenses, and sales for Avista's electric and natural gas services in its consolidated Washington, Idaho and Oregon jurisdictions for the period 2005 through 2014. The graph also shows the expected changes for the period 2015 through 2018. The red line on the graph shows the growth in net utility plant investment, which is representative of growth in rate base. The green line on the graph shows non-fuel O&M and A&G expenses. The purple and blue lines on the graph show the changes in retail kilowatt-hour (kWh) sales and retail therm sales, respectively, for the same time period. As can be seen from the illustration, both net plant investment and non-fuel O&M and A&G have been growing at a much faster pace than sales over time, and this mismatch is expected to continue to the future.



Although Avista has taken measures to cut its costs, as can be seen by the dip in the green data point line (Non-Fuel O&M/A&G) in 2013, these measures have only slowed the growth in expenses. Costs still continue to grow at a faster pace than sales, continuing the impact of attrition going forward.

Looking back further in time, from the 1950s through roughly 1980, there was steady growth in the number of customers, which was also combined with rapid growth in use-per-

customer. But, beginning around 1980, the use-per-customer began to decline dramatically. The decline in use-per-customer was due in part to Avista's energy efficiency programs that began in 1978, as well as the regional and national efforts generally to encourage consumers to use energy more efficiently. The change from rapid growth in use-per-customer to a significant reduction in use-per-customer beginning around 1980 had a direct impact on Avista's retail rates.

Stated differently, during the 1950s there was rapid growth in net plant investment, but it was accompanied by rapid growth in use-per-customer, combined with steady growth in the number of customers. The net result was retail prices that were either flat or declining, due in large part to the annual growth in revenues being sufficient to cover the annual growth in costs.

This reduction in use-per-customer persists today. In addition, Avista's annual customer growth, and total sales growth, is currently approximately 1%, and it is expected to continue at or near this level for the foreseeable future. Net plant investment and operating expenses, however, are growing at a faster pace. Avista continues to replace 60 to 100-year old facilities (e.g. Little Falls and Nine Mile Hydro Facilities, distribution poles etc.), and this annual cost of new investment is greater than growth in revenue. A utility's obligation to serve all customers with safe, reliable service, while maintaining a high level of customer satisfaction, requires continued investment in facilities to accomplish these objectives.

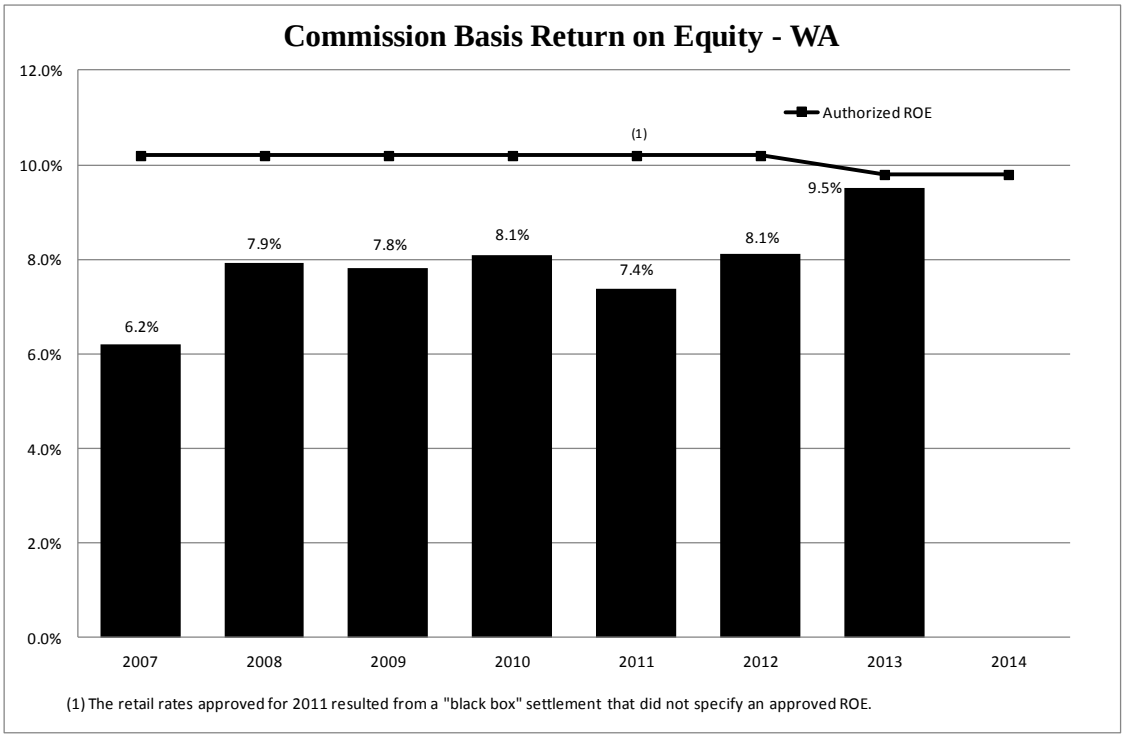
As noted above, because annual costs are growing at a faster pace than revenues, it is necessary to increase retail rates so that total revenues are equal to total costs. These are the circumstances facing not just Avista, but many investor-owned and consumer-owned utilities across the country, and it is the primary reason Avista has experienced attrition in recent years, and expects to continue to be impacted by attrition in the foreseeable future.

2) **Your organization's preferred ratemaking mechanism(s) for addressing each of the forms of earnings attrition identified in (1) above, e.g., an attrition allowance, pro forma plant in rate base, construction work in progress (CWIP) in rate base, or future test year. Please include a discussion of the benefits and shortcomings of your preferred mechanism and of alternative mechanisms. Also discuss whether the different causes of attrition require different ratemaking solutions, in your respective view.**

Avista Response:
In Avista's 2012 electric and natural gas general rate cases (GRCs), Docket Nos. UE- 120436 and UG-120437, Avista proposed attrition adjustments based on its electric and natural gas Attrition Studies filed in those proceedings. A similar approach was used in Docket Nos. UE-140188 and UG-140189, as well as in Avista's current on-going filing, Docket Nos. UE-150204 and UG-150205.

Use of attrition allowances over the last few years has been Avista's preferred approach to address utility operating expenses and capital investment (rate base) that are growing at a much faster pace than retail sales revenues. Under these circumstances, prior ratemaking practices using historical test periods with limited pro forma adjustments, which had been the method used in Washington in past years, did not provide for adequate and timely recovery of costs, and the opportunity to earn a reasonable return.

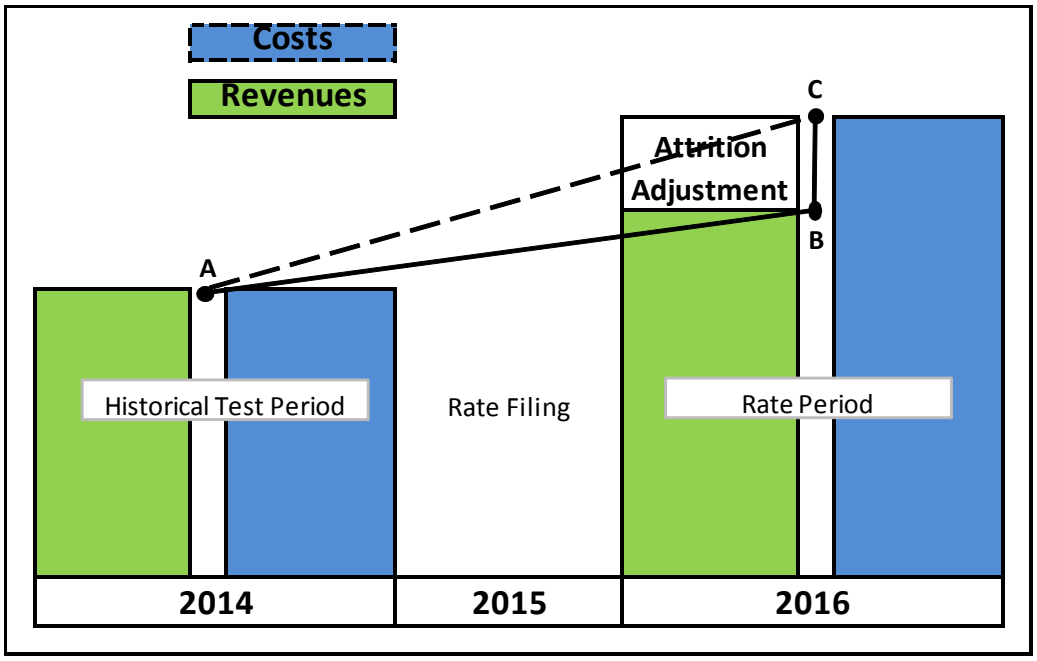
As can be seen from the chart below, from the period 2007 to 2012, Avista's combined electric and natural gas normalized commission basis report (CBR) return on equity (ROE) was at least 200 basis points or more below the ROE authorized for Avista during that time period. In 2013 Avista earned closer to its authorized ROE[5] in its Washington jurisdiction, due in large part to the use of attrition analyses to establish retail rates for 2013 and 2014.[6]



[5] As of the date of these comments, Avista has not completed its 2014 normalized Commission Basis Report (CBR). Avista's CBR is due to be filed with the Commission by April 30, 2015.

[6] Although the level of electric and natural gas revenue increases approved in Docket No. UE- 120436, UG-120437, for the period 2013 and 2014 were through a multi-party settlement agreement approved by the WUTC, there was disagreement on the use of an attrition adjustment in the determination of those revenue increases. The Commission, however, noted at page 4 of Order 09, paragraph 10, "The Commission finds, on the basis of the evidence presented, that consideration of attrition in setting rates for 2013 is appropriate." Furthermore, at page 27 paragraph 70, it stated, "We agree with the Company and Staff that the proposed 2013 rate increase is based significantly on attrition."

The following chart illustrates how an Attrition Adjustment, over time, provides additional revenues to cover the growth in costs that are increasing at a faster pace than revenues.



The chart above is illustrative of a general rate case filed in 2015, using a 2014 historical test period and a 2016 rate year where new rates would be in effect. Between 2014 and 2016, Costs (from Points A to C) are increasing at a higher rate than Revenues (from Points A to B). The Attrition Adjustment provides additional revenues to make up the difference between the higher growth in costs, and the lower growth in revenues, such that the "Revenues" for 2016 are equal to the "Costs" in 2016, including the authorized return on investment. Without this "Attrition Adjustment," if the utility's revenues are designed to cover only the historical test period level of expenses with limited pro forma adjustments that do not reflect total costs expected during the rate year, earnings erosion and the inability to earn its authorized return would occur.

The Attrition Adjustment has been Avista's preferred approach in recent years in order to establish rates for a utility and its customers that properly match revenues, expenses and rate base (matching principle) during the rate period, and result in rates "that are just, fair, reasonable, and sufficient" and allow the utility the opportunity to earn a fair return as authorized by the Commission. With any method used to establish utility rates, the goal should be to properly match revenues, expenses and rate base during the period the new rates are in effect.[7]

[7] For example, the rate making treatment over the last several years has been different between Avista's jurisdictions (Washington, Idaho and Oregon). Oregon uses a forecasted test period to reflect rates during the rate year. In the State of Idaho, although we begin with a historical test period, pro forma adjustments are made to more closely reflect the costs, and return, associated with providing service to customers for the future rate year.

Historically, inclusion of construction work in progress (CWIP) alone would not provide Avista with recovery of its costs during the rate year, as this would not compensate the utility for recovery of any future investment which will occur during the rate period. In regards to the use of pro forma studies or forecasted test periods, if they do not take into consideration capital expenditures or other costs during the rate year, they will not provide Avista an opportunity to earn its allowed rate of return.

3) **If your organization prefers the Commission adhere to a historical test year ratemaking approach, please discuss why it would or would not be appropriate to consider potential earnings attrition in that historical year context.**

Avista Response:
Please see Avista's responses to questions 1) and 2).

4) **If your organization has a preferred mechanism(s), please discuss the requirements and parameters necessary for calculating the adjustment(s). Please include in your comments responses to the following questions:**
   a. **Should an attrition analysis include historical data only?**
   b. **Should rate-year capital budgets be considered?**
   c. **Should there be a "bright-line" cutoff date for including pro forma plant in rate base?**
   d. **What level of precision should be expected for projected capital budgets (budgeted to actual) for ratemaking?**

Avista Response:
Avista's Attrition Study methodology, used in recent GRCs, uses normalized expense and rate base data for prior years from Commission Basis Reports to develop growth trends in expenses and rate base. The data in the Commission Basis Reports reflect normalized numbers based on normalizing methods previously approved by the Commission. As discussed further below, adjustments to these growth trends may be necessary (up or down), based on the best available information, in order to reflect expectations during the rate year.

The annual growth rates from these trends are applied to test year expenses and rate base to arrive at the level of expenses and rate base for the rate year. Power supply revenues and expenses for the rate year included in the electric Attrition Study are based on those developed using the Company's AURORA model, and other adjusted power supply costs, all of which are based on methodologies previously used and approved for ratemaking in Washington. Retail revenues for the rate year are based on the Company's most recent retail load forecast. The Company's methodologies employed for its load forecast have been refined over time and have been shared regularly with stakeholders in the Integrated Resource Planning processes in Technical Advisory Committee meetings.

a. Should an attrition analysis include historical data only?

Avista Response:
An attrition analysis should take into consideration the best available information in the development of retail rates for the specific rate period. This may mean historical only, if the historical time period is representative of what is expected during the rate year. However, if rate year costs are expected to diverge from that historically experienced by the utility, consideration of changes expected in the rate period, up or down, should be considered in order to properly reflect costs during the rate period. Both historical and future data is relevant, in that, year by year changes in actual costs and future expected costs is instructive in understanding the appropriate level of costs and investment to include in the determination of retail rates for a specific rate year.

b. Should rate-year capital budgets be considered?

Avista Response:
Yes, see Avista's response to 4.a.

c. Should there be a "bright-line" cutoff date for including pro forma plant in rate base?

Avista Response:
No, see Avista's response to 4.a.

d. What level of precision should be expected for projected capital budgets (budgeted to actual) for ratemaking?

Avista Response:
Avista can appreciate the concerns by this Commission, or other parties, of the use of forecasted or projected budgets for certain expenses or capital expenditures for ratemaking purposes. However, certain precautionary steps can be taken to protect customers and the utility, and ensure costs included in rates are representative of the actual costs that will be incurred during the future rate period, e.g., specific reporting requirements[8], tracking mechanisms, rates "subject to refund", or "true-up" mechanisms, to name a few, which allow the Commission the opportunity to review actual costs versus forecasted costs during a future rate period.

[8] For example, in Avista's 2012 GRC, Docket Nos. UE-120436 and UG-120437, at Order No. 9, p. 38, paragraph 115, the Commission ordered Avista to provide capital expenditure plans as follows: (1) capital expenditure plan for 2014 on or before September 30, 2013; and (2) updates on changes in meeting its capital expenditure plan for 2014 and reports on progress in making such capital improvements on June 1, September 1, and December 1, 2014, respectively, for the previous quarters.

5) Please provide any other information, discussion, analysis, or documentation you believe would help inform the Commission on this issue.

Avista Response:

There are established guidelines in the utility industry which provide guidance on setting rates in a general rate case proceeding, and appropriate ratemaking adjustments, to achieve the objective of matching revenues, expenses and rate base, and providing a utility the opportunity to recover its costs and earn a fair return for shareholders. The Rate Case and Audit Manual (NARUC Manual), prepared by the NARUC Staff Subcommittee on Accounting and Finance (Summer 2003), provides guidance in processing a general rate case filed by a utility. The following excerpts from page 4 of the NARUC Manual provide instruction as to the purpose of the manual:

> This manual has been prepared by the National Association of Regulatory Utility Commissioners (NARUC) Staff Subcommittee on Accounting and Finance as a guideline for state, territory, and federal regulatory utility commission personnel.[9] It is not our intent to provide a checklist for use by commission auditors, accountants or analysts.[10] Rather, it is our intent to set forth the most common, basic regulatory principles, processes, and procedures used by many regulatory commissions to examine and investigate general rate applications. We anticipate that each regulatory jurisdiction will have areas of uniqueness and specific areas of differences when it comes to examining a utility's revenue requirement and operating earnings. Recognizing that these differences exist, we have tried to present the basic steps of the rate case investigation in such a way that revisions and changes can be made by the individual jurisdictions while maintaining the overall usefulness of the more general guidelines. (emphasis added)
>
> An example of a common difference among the jurisdictions is the test year used. Some states use an average historic test year, others use a year-end historic test year, and others use projected, future test periods. Yet, this difference does not generally change the nature or importance of the test year, nor does it change the basic list of elements that are included in the rate base or the operating income statement.

Some of the principles in the NARUC Manual directly address the attrition Avista is experiencing, and, in fact, support the use of appropriate adjustments to ensure that the new retail revenues resulting from a general rate case will provide recovery of utility costs, along with a reasonable opportunity to earn a fair return. Some of these important principles are included in the following excerpts from the NARUC Manual:

[9] The term "Commission" used throughout the NARUC Manual refers to the individual state, territory, or federal regulatory commission that is examining and investigating the general rate application.
[10] The term "auditor" used throughout the NARUC Manual refers collectively to auditors, accountants, and analysts.

1. Whether using a future or historic test year, the auditor should judge the appropriateness of the test year that has been proposed. Is it representative, after adjustments, of the period in which rates take effect? (Page 10) (emphasis added)

2. When looking at an historic test year, one of the first questions asked is whether the test year is too stale to make it a reasonable basis upon which to establish rates for a future period. In looking at the appropriateness of the test year (and whether it might be too old), one should look at what has happened since the end of the test year and the current time. (Page 10) (emphasis added)

3. In looking at the months beyond the end of the test year, have the growth rates for rate base, expenses, and revenues all remained fairly close and constant, maintaining the test year relationship among these three elements, or has one element changed dramatically, making the test year out of kilter with current operations? If so, can this situation be resolved through adjustments to the test year? (Page 10) (emphasis added)

4. A utility's rate filing commonly begins with test year booked numbers, which are then adjusted to represent anticipated, normalized operations for the period that the rates will take effect. (See Revenue Requirement Computation example toward the end of this document.) Several types of adjustments may be included, and these adjustments may be referenced by different names in different jurisdictions. Commonly, these adjustments will include correcting adjustments (e.g., the removal of prior period items from the test year), normalizing adjustments (e.g., adjusting revenues for normalized weather conditions or for a normalized level of expenses), and pro forma adjustments (e.g., the reflection of authorized salary increases into the test year figures). In general, the pro forma adjustments can be viewed as a ratemaking attempt to transform the relationship that exists between the elements of cost of service (revenues, expenses, taxes, and investment) during the test year to one that would take place during the period that the rates resulting from the rate proceeding take effect. One is trying to identify circumstances during the test year, or beyond the end of the test year, that impact the on-going expenditures or revenues of the utility. (Page 15) (emphasis added)

5. In reviewing the prudence and reasonableness of the adjustments proposed by the utility, the auditor should ultimately keep in mind that the ultimate purpose of the review is to determine a revenue requirement and customer rates that are just, fair, reasonable, and sufficient. (Page 15) (emphasis added)

6. The auditor should not only review the utility's proposed adjustments, but should also look for the adjustments that have *not* been made. Are there adjustments missing that if made would make the test year more reflective of normal, on-going operations? (Page 15) (emphasis added)

7. Additionally, one will want to look at a multi-year comparison of annual revenue to obtain a view of the trend for the utility. Is it growing and if so, is the growth relatively consistent? Is the growth related to new customers or additional usage of

existing customers? (The answer to this question may help explain whether the growth in revenue is consistent or inconsistent with growth in plant.) Are revenues and expenses growing together? (Page 31) (emphasis added)

As noted above the ultimate purpose of the review, and, therefore, any general rate case proceeding, is to establish rates for a utility and its customers, that are just, fair, reasonable, and sufficient to allow a utility the opportunity to earn a fair return as authorized by the Commission. The goal is to establish results which determine rates appropriate "during the rate year." While there may be different approaches, the "results" must meet the matching principle and provide a fair, just, reasonable and sufficient outcome for the utility and its customers. Recognizing that different approaches can be used to appropriately match revenues, expenses and rate base during the rate year, the Company believes that the Commission should maintain flexibility in its approach depending on the circumstances of each utility.

The Company appreciates the opportunity to provide these comments and we look forward to participating in the workshop scheduled for April 16, 2015. If you have any questions please contact Liz Andrews at 509-495-8601 or at liz.andrews@avistacorp.com.

Sincerely,

Kelly Norwood
Vice President, State & Federal Regulation