BEFORE THE WASHINGTON

UTILITIES & TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

AVISTA CORPORATION d/b/a AVISTA UTILITIES,

Respondent.

DOCKETS UE-170485 & UG-170486 (*Consolidated*)

RESPONSE TESTIMONY OF MARK E. GARRETT (MEG-1T)

ON BEHALF OF

PUBLIC COUNSEL

OCTOBER 27, 2017

RESPONSE TESTIMONY OF MARK E. GARRETT (MEG-1T)

DOCKETS UE-170485 and UG-170486 (*Consolidated*)

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Exhibit MEG-5	HydroOne Cap Structure
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1 **I. WITNESS IDENTIFICATION AND PURPOSE OF TESTIMONY**

2 **Q: Please state your name and business address.**

3 A: My name is Mark Garrett. I am the President of Garrett Group LLC, an Oklahoma based
4 firm specializing in public utility regulation, litigation, and consulting services. My
5 business address is 4028 Oakdale Farm Circle, Edmond, Oklahoma 73013.

6 **Q: Please describe your educational background and your professional experience**
7 **related to utility regulation.**

8 A: I am an attorney and a certified public accountant. I work as a consultant in the area of
9 public utility regulation. I received my bachelor's degree from the University of
10 Oklahoma and completed postgraduate hours at the Stephen F. Austin State University
11 and at the University of Texas at Arlington and Pan American. I received my juris
12 doctorate degree from Oklahoma City University Law School and was admitted to the
13 Oklahoma Bar in 1997. I am a Certified Public Accountant licensed in the States of
14 Texas and Oklahoma with a background in public accounting, private industry, and utility
15 regulation. In public accounting, as a staff auditor for a firm in Dallas, I primarily
16 audited financial institutions in Texas. In private industry, as controller for a mid-sized
17 ($300 million) corporation in Dallas, I managed the Company's accounting function,
18 including general ledger, accounts payable, financial reporting, audits, tax returns,
19 budgets, projections, and supervision of accounting personnel. In utility regulation, I
20 served as an auditor in the Public Utility Division of the Oklahoma Corporation
21 Commission from 1991 to 1995. In that position, I managed the audits of major gas and
22 electric utility companies in Oklahoma. Since leaving the Commission, I have worked on
23 rate cases and other regulatory proceedings on behalf of various consumers and consumer

1 groups. I have provided testimony before the commissions in the states of Alaska,
2 Arizona, Arkansas, Colorado, Florida, Massachusetts, Nevada, Oklahoma, Texas, and
3 Utah. My qualifications were accepted in each of those states. My clients primarily
4 include large industrial customers, large gaming customers in Nevada, large hospitals and
5 hospital groups, universities, cities, large commercial customers and solar industry
6 interveners. I have also testified on behalf of commission staffs and offices of attorneys
7 general. A more complete description of my education and experience is provided in
8 Exhibit No. MEG-2.

9 **Q: On whose behalf are you testifying?**

10 A: I am testifying on behalf of the Public Counsel Unit of the Washington Attorney
11 General's Office (Public Counsel).

12 **Q: What is the purpose of your testimony in this proceeding?**

13 A: Garrett Group, LLC has been engaged to present recommendations and ratemaking
14 policy considerations related to the Company's proposed cost of capital, revenue
15 requirement, and attrition adjustments in this general rate case for its electric and gas
16 utilities. My testimony presents Public Counsel's recommendation regarding Avista's
17 revenue requirement and attrition adjustment. David Garrett presents Public Counsel's
18 recommendation regarding Avista's cost of capital and capital structure.

19 ## II. AVISTA'S PROPOSAL

20 **Q: What is the Company proposing in this case with respect to its revenue**
21 **requirement?**

22 A: The Company is proposing a multi-year plan in which it receives large rate increases in
23 base revenues in year one for both the electric and gas utilities, followed by additional

1 attrition increases in years two and three. The Company's proposed increases, including
2 the cumulative effect of its proposed increases, are set forth in the table below:

Table 1: Avista's Proposed Rate Increases

	Year 1	Year 2	Year 3	TOTAL
Electric Rate Increase	$61.4M	$61.4M	$61.4M	$184.2M
Additional Rate Increase		$14.0M	$14.0M	$28.0M
Additional Rate Increase			$14.4M	$14.4M
Total Electric Increase	**$61.4M**	**$75.4M**	**$89.8M**	**$226.6M**
Gas Rate Increase	$8.3M	$8.3M	$8.3M	$24.9M
Additional Rate Increase		$4.2M	$4.2M	$8.4M
Additional Rate Increase			$4.4M	$4.4M
Total Gas Increase	**$8.3M**	**$12.5M**	**$16.9M**	**$37.7M**
Total Electric and Gas Increase	**69.7M**	**$87.9M**	**$106.7M**	**$264.3M**

3 In its Application, the Company presented four ratemaking studies related to its requested
4 increases. These studies are described by Company witness Elizabeth M. Andrews, as
5 follows:

6–11 1) **Traditional Pro Forma Study** – The Traditional Historical Modified Test Year Pro Forma Study. The results of this study for Rate Year 1 is $37.5 million for electric and $4.5 million for natural gas. The Company contends this approach is insufficient to provide the Company to earn the proposed ROR requested in this case.[1]

12–18 2) **EOP Rate Base Study** – An End of Period (EOP) Rate Base Study, which also employs the use of an adjusted capital structure. The Company's proposed rates were derived based on this Study, which results in an increase in Rate Year 1 of $61.4 million for electric, and $8.3 million for natural gas.[2] A K-Factor is then applied to this study to determine the revenue increases for rate years two and three of the 3-year plan.

[1] Direct Testimony of Elizabeth M. Andrews, Exh. EMA-1T at 7:13-21.
[2] Andrews, Exh. EMA-1T at 8: 1.

1 2 3 3) **K-Factor Study** – A study that employs the use of an annual revenue escalator (K-Factor) for a multi-year period to escalate the revenue adjustments.

4 5 6 4) **Rate Year Study** – A study that incorporates all of the planned capital investments, operating expenses, and revenues for each year of the Three-Year Rate Plan.

7 The EOP Rate Base study is the basis for the Company's requested rate increase in year
8 one, and the K-Factor study is the basis for the requested rate increases in years two and
9 three.[3]

10 **Q: Does the Company's Traditional Pro Forma Study conform with a traditional**
11 **historical modified test year approach?**

12 A: No. Avista's Pro Forma study does not conform to a traditional historical test year
13 approach in my experience. Typically, a traditional modified test year approach
14 synchronizes the major cost components of the revenue requirement – rate base,
15 revenues, operating expenses, depreciation and taxes – at a given point in time – a test
16 year. Further, this approach only allows adjustments for known and measurable changes
17 that occur: (1) during the test year or (2) shortly after the test year cut off to not disturb
18 the alignment of these important ratemaking components. The Company's Pro Forma
19 Study starts with a historical test year identified as 2016, but projects expense levels
20 through 2018 – two years after the test year's conclusion – for many cost components,
21 such as payroll, benefits, and property taxes. These adjustments effectively turn what the
22 Company refers to as its "Traditional Pro Forma Study" into a projected test year
23 approach for these major expense items.

24 With respect to plant in service, the Company's Pro Forma Study includes any

[3] Andrews, Exh. EMA-1T at 7: 25-28.

1 plant additions greater than one-half of one percent of rate base through the end of 2017,
2 a full year after the test year's end. This further distorts the historical-cost rate-base
3 approach, and adds $34.9M to electric rate base and $17.8M to natural gas rate base.
4 For these reasons, I would not characterize the Company's "Pro Forma Study" as
5 a true historical-cost based test year approach. Instead, I recognize this study as being
6 based on a partially projected test year, which has been liberally adjusted in the
7 Company's favor. As a result, the Company's proposal therefore represents a very
8 generous approach for setting its revenue requirement.
9 **Q: Why do you say the Pro Forma Study has been adjusted in the Company's favor?**
10 A: In the Company's Pro Forma Study, Avista captures escalated costs in partially
11 projecting the test year, but Avista ignores potential cost savings that may occur in those
12 future periods. This skews the information provided to the Commission and violates the
13 Matching Principle.
14 **Q: Is the Company's EOP Study a traditional End of Period approach?**
15 A: No. Again, in my experience, a true "end of period" rate base approach, as opposed to an
16 average rate base approach, generally uses rate base balances at the end of the test year
17 rather than the average of the monthly balances that occur during the test year. In the
18 Company's EOP approach, however, Avista includes plant balances not at the end of the
19 test year, but at the end of the *subsequent* year, 2017.
20 Additionally, the difference between the EOP study and the Pro Forma study is
21 that all plant through the end of 2017 is included in rate base, not just those projects
22 greater than one-half of one percent of rate base. With respect to operating expense, the
23 EOP study, like the Pro Forma Study, projects payroll and property taxes out through

1 2018. As a result, Avista's EOP approach is again a based upon a projected test year.

2 **Q: Has this Commission expressed concerns about using projected future levels of**
3 **expense and capital expenditures rather than historical costs as the basis for setting**
4 **rates?**

5 A: Yes. In its Order for Avista's 2015 rate case (Dockets UE-150204 and UG-150205), the
6 Commission stated:

> 7 [We] are concerned about authorizing a practice that simply projects
> 8 future levels of expense and capital expenditures that may, as multiple
> 9 commenters point out, "become a 'self-fulfilling prophecy' where there
> 10 is an incentive for rates of capital expenditure to be driven by an effort
> 11 to match earlier projections."[4]

12 Avista's approach, as I describe above, includes cost projections that mirror the
13 Commission's concerns.[5] The Commission has also expressly rejected using a future test
14 year approach to ratemaking.[6]

15 **Q: What is the Company's rationale for using a projected test year followed by**
16 **additional attrition adjustments for years two and three?**

17 A: The Company's rationale is set forth in the testimony of Mr. Morris. He presents several
18 graphs tracking the Company's investment level increases and kwh sales from 1889
19 forward. His conclusion is that revenues are not keeping up with costs. Mr. Morris
20 makes the following statement:

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[4] *WUTC v. Avista Corp.*, Dockets UE-150204 & UG-150205, Final Order No. 05 at 44 (Jan. 06, 2016).

[5] *WUTC v. Avista Corp.,* Dockets UE-160228 and UG-160229, Order 06, Final Order Rejecting Tariff Filing ¶ 68 (Dec. 15, 2016) (Avista's results in recent years appears to be the realization of the Commission's earlier expressed concern that authorizing a practice that simply projects future levels of expense and capital expenditures may become a self-fulfilling prophecy where capital expenditures are driven by an effort to match earlier projections.).

[6] *WUTC v. Pacific Power & Light Co.,* Docket UE-140762, Final Order 08 ¶ 8 (Mar. 25, 2015); *WUTC v. Puget Sound Energy*, Dockets UE-111048 and UG-111049, Final Order 08 ¶¶ 96-98 (May 7, 2012).

1 Post-1980 – because annual costs were growing at a faster pace than
2 revenues, it was necessary to increase retail rates each year so that total
3 revenues were equal to total costs. These are the circumstances currently
4 facing not just Avista, but many investor-owned and consumer-owned
5 utilities across the country, and is the primary reason Avista has requested
6 electric and natural gas revenues through this filing.[7]

7 This statement leaves the impression that utilities across the country are filing for
8 significant rate increases each year to keep up with cost level escalations that are out of
9 their control. The truth is that attrition adjustments went out of vogue in the 1980s after
10 the double-digit inflation years subsided.

11 **Q: Have you found cost escalations similar to those presented by Avista to be the norm**
12 **in jurisdictions across the country?**

13 A: No. This has not been my experience. Instead, I have seen many instances in which the
14 cost of capital has been declining sharply over the past several years and many utilities
15 have been able to avoid rate substantial increases due to lower debt and equity costs. In
16 some cases, for example, when companies are faced with significant costs associated with
17 environmental compliance mandates beyond their control, I have seen commissions
18 award narrowly tailored rate increases and other measures to address the special
19 circumstances. In this case, however, Avista's requested rate increases are *not* the result
20 of environmental mandates or cost increases beyond the utility's control. The types of
21 discretionary expenditures for which Avista seeks recovery in this case do not warrant the
22 extraordinary rate treatment the Company is seeking.[8]

23 **Q: Briefly describe the approaches you have seen in other jurisdictions.**

24 In most of the states in which I regularly practice, commissions adhere to use of standard

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[7] Direct Testimony of Scott L. Morris, Exh. SLM-1T at 13:22-14:4.

[8] Avista's proposed increases are largely to replace existing distribution assets and pay for wage increases.

1 historical test year approaches. They typically do not significantly alter their long-
2 standing ratemaking methodologies or standards because a utility is experiencing cost
3 increases, even if environmental compliance mandates drive cost increases beyond the
4 utility's control. Thus, while the utilities in Oklahoma and Texas have received some,
5 albeit small, rate increases related to environmental compliance costs, the utilities in
6 Nevada have actually received rate decreases over the past six year period. In the scores
7 of rate cases I have been involved in, I have not seen commissions in these jurisdictions
8 alter their approach to provide the type of extraordinary relief Avista is seeking in this
9 case. To the contrary, the commissions have continued to require companies to provide
10 historical cost data and test year cutoffs as a general rule.

11 **Q: In your experience, Mr. Garrett, what approach do commissions in other**
12 **jurisdictions take when a utility requests an allowance for costs incurred after test**
13 **year end?**

14 A: In Oklahoma, the commission recognizes known and measurable changes up to six
15 months after test year end. Any change after that date is not included, and the cutoff is
16 strictly observed. This means that any change included in rates has actually occurred by
17 the time the case goes to trial. Costs are not projected.

18 In Nevada, the same is true, except their cutoff is five months after test year end.
19 Thus, all rate base, revenues, operating expense, depreciation and taxes are updated to the
20 cutoff date. No capital additions or expenses incurred after that cutoff date is allowed in
21 rates.

1 In Texas, test year end is fairly rigidly observed for rate base accounts. Known
2 and measurable changes after test year end are, however, allowed for some expense items
3 such as payroll, more as a matter of practice than as a general rule.

4 III. THIS COMMISSION'S RATEMAKING STANDARD

5 **Q: What is the accepted ratemaking approach in Washington?**

6 A: My understanding is that the Washington Utilities and Transportation Commission uses a
7 *Modified Historical Test Year with Pro Forma Adjustments* approach, which means that
8 the ratemaking process starts with a historical test year adjusted for *known and*
9 *measurable changes* that occur during the test year or shortly after test year end.[9] On
10 occasion, when warranted by the circumstances, the Commission has allowed expenses
11 or investments that occurred after the test year to be included in the ratemaking formula.
12 The Commission has also, in some circumstances, approved more extraordinary measures
13 such as attrition adjustments, when necessary to recover cost increases that are beyond
14 the control of management. However, the standard for an attrition adjustment is clear.
15 According to the Commission:

> 16 It is necessary for Avista and any other utility seeking an attrition
> 17 adjustment to demonstrate that its need to invest in non-revenue
> 18 generating plant, particularly distribution plant, is so necessary and
> 19 immediate as to be beyond its control.[10]

20 **Q: Do the Company's cost studies presented in this case comport with the**
21 **Commission's approach?**

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[9] *See*, *WUTC v. Avista Corp.*, Dockets UE-160228 and UG-160229, Order 6, Final Order Rejecting Tariff Filing at 47 (Dec, 15, 2016).

[10] *See, WUTC v. Avista Corp.*, Dockets UE-160228 and UG-160229. Order 7, Order Denying Petition for Reconsideration or, in the Alternative, Rehearing at 18 (Feb. 27, 2017).

1 A: No. The recommended EOP study is a projected test year through 2017 with many
2 expenses escalated through 2018 based solely on internal Company projections. Further,
3 Avista's requested increases for years two and three are effectively attrition adjustments
4 for costs that are not outside the Company's control. In fact, the cost increases that
5 Avista is projecting for its three year plan are for costs that are squarely within the control
6 of management. The cost increases in this case are primarily for distribution plant
7 replacement and payroll cost increases. In my experience, costs that are beyond the
8 control of management are generally acts of God (such as storms), acts of governmental
9 authorities (such as environmental mandates), commodity cost increases (such as natural
10 gas price spikes), or unforeseen catastrophes (such as pipeline explosions not covered by
11 insurance). It would be very unusual for utility management to assert that they are unable
12 to control the very costs they were hired to control, including ongoing levels of capital
13 investment and operating costs of the company.

14 **Q: Does the Company assert that the increases in years two and three are outside their**
15 **control as required by the Commission?**

16 A: No. They merely assert that there are consequences for not approving their requested
17 increase.[11] Yet there are consequences for every decision by management to spend or not
18 spend money. In my opinion, the Company has not even attempted to demonstrate that
19 the increases in years two and three meet the Commission's standard for attrition. Again,
20 this standard only applies to costs escalating *beyond the Company's control*. The
21 problem with attrition adjustments in general is that – as this Commission has recognized

[11] *See*, Morris, Exh. SLM-1T at 19:22-20:2.

1 – allowances for attrition become self-fulfilling prophecies. Given the money to spend,
2 management will spend it and then ask for more.

3 **Q: Are there other concerns with the Company's request that the Commission approve**
4 **attrition adjustments and set rates based in part on projected future costs?**

5 A: Yes. The most important concern with setting rates based on partially projected data, as
6 requested in this application, is that the Company seeks recovery in advance for cost
7 increases it anticipates will occur in the rate-effective period, but provides no offsetting
8 adjustments for events and changes in the rate-effective period that will tend to mitigate
9 or reduce costs. Each of the Company's four studies presented have some objectionable
10 cost projections that, in my opinion, extend too far beyond the test year. Of the four
11 studies presented, the Traditional Pro Forma Study most closely adheres to this
12 Commission's modified cost-based approach. With some routine adjustments, as
13 discussed in the testimony below, this cost of service study is the most appropriate
14 method presented and is sufficient for setting rates in this proceeding.

15 **Q: Are the Company's attempts to avoid regulatory lag based on projected cost**
16 **increases appropriate?**

17 A: No. Regulatory lag is by far the Commission's best tool for ensuring that regulated
18 utilities control costs. When rates are set to recover a certain level of costs that reflect
19 adjustments for known and measureable changes, the utility has every incentive to ensure
20 that unavoidable cost increases are offset with corresponding cost decreases. This causes
21 utilities to look for every efficiency measure available and is what companies in
22 competitive markets must do all the time. Since the Commission serves as the surrogate
23 for competition, it is important for the Commission not to abandon its best tool for

1 imitating the market. Utilities routinely attempt to eliminate regulatory lag, but these
2 attempts should be rejected.
3 Whenever a regulated utility can no longer manage its company in a manner that
4 achieves a reasonable return, it has the remedy of filing a rate case. This remedy is not
5 available to companies that operate in competitive markets. This gives regulated utilities
6 a safety net that competitive companies do not enjoy. Thus, the slight discomfort that
7 comes from regulatory lag should be left in place to encourage regulated companies to
8 operate as efficiently as they can – in effect, to operate as efficiently as they would have
9 to in a competitive environment. On an ongoing basis, revenue growth and productivity
10 gains (i.e., reduced operating costs) encouraged through regulatory lag are generally
11 sufficient to sustain a utility's earnings through the rate-effective period. If cost increases
12 truly cannot be sufficiently offset with increased revenues and operating efficiencies, the
13 utility has the option to file a rate case.
14 For Avista, however, there are several events on the horizon during the rate effective
15 period that have the prospect of significantly lowering the Company's costs which are not
16 accounted for in the Company's current filing. These omissions raise questions as to
17 whether the Company will experience any revenue deficiency if its ROE and capital
18 structure are set at appropriate levels. Based on my review of the application, the
19 Company has not met its burden to show that its projected capital investments and cost
20 escalations during the rate-effective period are beyond its control or sufficient to justify
21 the relief it seeks.

1 **IV. SIGNIFICANT COST SAVINGS OVER THE RATE-EFFECTIVE PERIOD**

2 **Q: What are the significant cost savings over the rate effective period that are not taken**
3 **into account in the Company's filing?**

4 A: There are several significant events that are likely to produce tremendous cost savings on
5 the horizon for Avista that are not mentioned in the Company's filing. These events will
6 all transpire over the three year period of the Company's Multi-Year Rate Plan cycle, and
7 yet these events are not accounted for in the Company's request for relief. These events,
8 when combined, have the potential of offsetting all of the Company's projected cost
9 increases and alleged regulatory lag. These events include (1) the pending merger, (2)
10 significant debt refinancing, (3) a new depreciation study, and (4) potential federal
11 income tax code changes.

12 **Q: Please describe how each of these events may offset the Company's three year**
13 **projected cost increases.**

14 A: Each of these events will potentially result in cost savings, as discussed in the section
15 below.

16 **A. The Pending Merger Could Offset Projected Cost Increases**

17 **Q: Please discuss the impact the pending merger may have on the Company's three**
18 **year projected cost increases.**

19 A: On July 19, 2017, after this rate case was filed, Avista announced its planned merger with
20 Toronto-based HydroOne Limited (HydroOne). Applications requesting approval of the
21 merger on or before August 14, 2018, have been filed in Washington, Oregon, Montana,
22 and Alaska, as well as with the Federal Energy Regulatory Commission (FERC).
23 According to an Avista Corporation press release, the proposed merger will create

1 efficiencies that "diversify and strengthen" the businesses. More specifically, Mayo
2 Schmidt, President and CEO of HydroOne stated,

3 This is allowing us to gain further efficiencies through enhanced scale and
4 increased purchasing power that will provide a strong foundation for the
5 future with material benefits to all of our stakeholders most importantly
6 the customers and communities we serve.[12]
7
8 Scott Morris, Avista Chairman, President, and CEO also noted,

9 The merger will provide some immediate cost savings that will be passed
10 on to our customers, as well as the opportunity for longer-term benefits
11 from efficiencies gained through the sharing of best practices, technology
12 and innovation"[13]

13 According to Avista's merger application, the cost savings would be "immediate," and
14 the Company currently plans to distribute a rate credit of about $31.5 million to
15 customers over a 10-year period.[14] According to recent news reports summarizing the
16 Company's merger application, "The $31.5 million represents the 'floor' of benefits that
17 will be flowed through to Avista's customers."[15]

18 The potential benefits described in the Company's statements would offset
19 Avista's need for rate relief, and the alleged benefits are likely to be accrued more
20 quickly than $3.15 million per year over 10 years.[16] For example, HydroOne's favorable
21 cost of capital metrics compared with Avista's requested cost of capital in this case. In
22 late 2016, HydroOne had an authorized 9.19 percent ROE, a 4.4 percent cost of long term

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[12] *See,* Exh. MEG-3, Globe Newswire, *Hydro One and Avista File Applications for Regulatory Approval of Merger* Press (Sept. 14, 2017, 4:05 PM ET). https://globenewswire.com/news-release/2017/09/14/1121420/0/en/Hydro-One-and-Avista-File-Applications-for-Regulatory-Approval-of-Merger.html.

[13] *Id*.

[14] *See*, Exh. MEG-4, Brian Walker, *Speak Up on Avista Merger*, Coeur d' Alene/ Post Falls Press (Sept. 23, 2017, 5:00 PM), http://www.cdapress.com/article/20170923/ARTICLE/170929914.

[15] *Id*.

[16] The testimony presented here does not presuppose that the Company will be able to show net benefits from the merger sufficient to conclude that the merger is in the public interest. Instead, the testimony merely points out that, based upon Avista's own statements, it is premature to lock in Avista's projected rate increases in anticipation of a merger that could make those increases unnecessary.

1 debt and a 60/40 debt-to-equity ratio in its capital structure, according to a 2016 EEI
2 investor update presentation.[17] These metrics are more in line with the downward trend
3 in utility capital costs that I have seen in other jurisdictions across the country, and in
4 efficiently managed companies. If these cost of capital metrics were applied to Avista's
5 investment levels today, they would more than eliminate the entirety of the Company's
6 requested Pro Forma Study increase, net of power costs. The table below illustrates how
7 each of HydroOne's cost of capital components, if applied in this case, would
8 significantly lower Avista's "needed" rate increase.

Table 2: Potential Savings Based on Adopting HydroOne's Cost of Capital Metrics	
Avista's Pro Forma Revenue Requirement (Net of Power Cost Adjustment)	$ 20,892
Adjust Avista's Requested ROE of 9.9% to HydroOne ROE of 9.19%	$ (8,081)
Adjust Avista's Requested Cost of Long Term Debt of 5.62% to HydroOne rate of 4.4%	$ (9,578)
Adjust Avista's Requested Debt/Equity Ratio from 51.5/48.5 to 60/40	$ (12,823)
Total potential savings by adjusting to HydroOne Cost of Capital	$ (30,482)
Avista's Pro Forma Revenue Requirement using HydroOne's Cost of Capital	$ (9,590)

9 None of HydroOne's cost of capital metrics are unusual or hard to obtain, for the
10 following reasons:

11 • The 9.19 percent ROE is a reasonable, yet very generous cost of equity, compared
12 to the Company's actual cost of equity;

[17] Exh. MEG-5, Hydro One, 51st EEI Financial Conference (Nov. 8, 2016), http://www.eei.org/meetings/Meeting_Documents/2016-11-FinConf-HydroOne.pdf.

1 - The 4.4 percent cost of debt is close to the average cost of debt for a utility with
2 Avista's debt ratings;
3 - A 60/40 debt to equity ratio is in line with the ratios commonly seen in the
4 competitive markets, when debt costs are as low as they are today.

5 In other words, these cost of capital related savings are all obtainable over time. In fact, I
6 believe most of the savings are obtainable over the three year period of the Company's
7 Multi-Year Rate Plan. The ROE is obtainable immediately and the cost of Long Term
8 Debt is obtainable over a slightly longer period, as the Company refinances its existing
9 debt and issues new debt for its planned construction programs. Finally, the revised
10 capital structure could be obtained over a short period, if the Company would primarily
11 use debt to finance its new capital expenditure projects. These adjustments are examples
12 of the ways Avista could pursue efficiencies within its control to make the Multi-Year
13 Plan with attrition adjustments unnecessary.

14 **Q: Why is the Avista's pending merger relevant to its rate case?**

15 A: This information is presented to illustrate how setting rates based on partially projected
16 cost estimates, as the Company suggests, without consideration of offsetting cost
17 mitigation opportunities during the same period, can unnecessarily burden ratepayers and
18 set rates well above the Company's actual revenue requirement. The Company is willing
19 to project with certainty the precise amount of revenue deficiency it will experience
20 based on its planned expenditures, but ignores the elephant in the room—the potential
21 effects the pending merger will have on its ability to achieve new efficiencies and
22 savings. It makes very little sense for the Commission to approve a series of significant

1 rate increases for ratepayers, with a three-year stay-out provision, just as the Company is
2 about to implement changes that could significantly lower its costs.

3 The pending merger is not an issue, of course, being litigated in this docket.
4 Parties will have the opportunity to fully examine, discuss, and weigh merger-related
5 issues as that case moves forward. However, based on the sheer magnitude of the
6 requested rate increases in this proceeding and the Company's insistence that earnings
7 erosion requires a multi-year rate plan, it would be ill-advised and inappropriate to
8 consider the acquisition as completely isolated from this rate case. After all, Avista is
9 alleging that the acquisition will produce significant benefits. Simply put, this case does
10 not exist in a vacuum.

11 **B. Avista's New Debt Issuances In 2018 Will Significantly Reduce Costs**

12 **Q: Please discuss how Avista's new debt issuances in 2018 may reduce costs.**

13 A: As discussed in the section above, Avista's existing debt costs at 5.62 percent are high.
14 In 2018, Avista has approximately $272 million of higher-cost Long Term Debt
15 maturing.[18] Avista will refinance this debt at current, significantly lower rates. Avista
16 also plans to issue new Long Term Debt for its capital expenditure programs. In all,
17 Avista plans to issue $470 million in Long Term Debt in 2018,[19] and $785 million
18 through 2020,[20] which marks the end of the three year rate plan. If the Company were
19 able to issue this debt at a 4.4 percent rate rather than at its current 5.62 percent rate,

[18] *See,* Exh. MEG-6C, Avista Response to Public Counsel Data Request No. 68.
[19] *Id*.
[20] *Id*.

1 Avista would save about $5.734 million per year in 2018[21] and $9.577 million per year
2 by the end of the three year rate plan period. [22]

Table 3: Potential Savings Based on Long Term Debt Refinancing	
Potential Annual Savings from 2018 Issuances	$(5,734,000)
Potential Annual LTD Refinancing Savings by 2020	$(9,577,000)

3 **Q: Is a 4.4 percent cost of Long Term Debt achievable for Avista?**

4 A: It is impossible to know at this point. Undoubtedly, though, Avista's new cost of Long
5 Term Debt will be much lower than the Company's current 5.62 percent. In my
6 estimation, the 4.4 percent provides a range of what the Company might be able to
7 achieve. It is consistent with the average cost of Long Term Debt for a company with
8 Avista's bond rating and consistent with the cost of Long Term Debt of other utilities in
9 rate cases I have been involved in recently. It is also consistent with the HydroOne's cost
10 of Long Term Debt. The chart below provides a sample of support for a 4.4 percent cost
11 of Long Term Debt.

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[21] Calculated as 5.62% - 4.4% x 470M.
[22] Calculated as 5.62% - 4.4% x 470M.

Table 4: Sampling of Comparative Long-Term Debt Costs

Description	Reference	Cost of Long Term Debt
HydroOne Limited	EEI Presentation[23]	4.40%
Sierra Pacific Power Co (SPPC)	Docket No. 16-06006[24]	4.12%
Public Service Co. of Oklahoma (PSO)	Cause No. PUD 17-151[25]	4.60%
Average Cost of Debt	NYU Publication[26]	4.50%
Average Cost of Long Term Debt – NPC Peer Group	Docket No. 17-06003[27]	4.27%

Moreover, it is important to remember that the 4.4 percent benchmark is not being used to propose an adjustment to the Company's requested revenue requirement; it is merely being used to make the point that the Company will be able to achieve cost savings over the three-year Multi-Year Rate Plan that are not accounted for in the Company's numbers. It is also important to remember that, while there is overlap between the savings from the refinancing of debt and the proposed merger, much of the Long Term Debt savings discussed in this section could be achieved absent the merger.

C. Avista's New Depreciation Study Could Materially Lower Rates

Q: Please describe how a new depreciation study could impact the Multi-Year Rate Plan?

[23] Hydro One, 51st EEI Financial Conference (Nov. 8, 2016), http://www.eei.org/meetings/Meeting_Documents/2016-11-FinConf-HydroOne.pdf.

[24] *See,* Exh. MEG-7, *Application of Sierra Pacific Power Co. for Authority to Adjust Its Annual Revenue Requirement for General Rates Charged to All Classes of Electric Customers and for Relief Properly Related Thereto*, Docket No. 16-06006, Original Filing Vol. 3, Statement F at 42-46 (Nev. PUC Jun. 6, 2016).

[25] *See,* Exhibit MEG-8, Oklahoma Corporation Commission Cause No. PUD 2017-00151, Schedule F-1 in the Public Service Company of Oklahoma's filed rate case application.

[26] Exh. MEG-9, *Ratings, Interest Coverage Ratios and Default Spread*, NYU Stern School of Business, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ratings.htm (last visited Oct. 26, 2017).

[27] *See*, Exh. MEG-10, *Application of Nevada Power Co. for Authority to Adjust Its Annual Revenue Requirement for General Rates Charged to All Classes of Electric Customers for Relief Properly Related Thereto*, Docket No. 17-06003, Direct Testimony of Charles J. Cicchetti at 20 (Sept. 12, 2017).

1 A: My understanding is that Avista intends to file a new depreciation study in Washington
2 before the end of the year. Although new depreciation rates typically have no impact on
3 Company earnings – provided they are implemented in the context of a rate case
4 proceeding – new depreciation rates will have a direct impact on ratepayer costs.
5 Furthermore, this impact can be material. In my opinion, it is premature to say that costs
6 are escalating faster than revenues, to the extent the utility needs a Multi-Year Rate Plan
7 to accommodate the increases, when we do not even know what depreciation costs will
8 be. It is possible that depreciation costs could be low enough that they would offset
9 much of the Company's requested increases particularly in years two and three. In other
10 words, I see no reason to commit to a significant rate increase in a multi-year rate plan
11 when a critical cost component is unknown at this time.

12 **D. A Material Change In Federal Tax Rates Could Impact Projected Costs**

13 **Q: What is the issue with a potential federal tax rate change?**

14 A: Congress and the current administration are contemplating major tax reform. This reform
15 could result in lower corporate tax rates. If a major tax rate reduction does occur, it will
16 substantially lower overall utility costs. These cost reductions will have to be passed on
17 to ratepayers. If a tax bill is passed this year or even next year, it could eliminate much
18 of the Company's perceived need for rate increases during the three year period of the
19 Multi-Year Plan.

20 When the Tax Reform Act of 1986 was passed, utilities across the country came
21 in for rate proceedings to significantly reduce overall rates. A similar tax reduction in the
22 near future would completely change all of the Company's projected overall cost

1 increases. In my opinion, it is too early, and unwarranted at this time, to commit to a
2 multi-year rate plan with such a significant potential cost decrease on the horizon.

3 **V. GENERAL DISCUSSION OF ATTRITION ADJUSTMENTS**

4 **Q: What is an attrition adjustment?**

5 A: Conceptually, attrition adjustments are an add-on to the revenue requirement that would
6 otherwise be determined in a rate case. The idea is that without the adjustment, the
7 utility's expected investment and operating cost levels will outpace revenues, leaving the
8 utility without a reasonable opportunity to earn its authorized return.

9 **Q: Is the concept of attrition contrary to the traditional ratemaking formula?**

10 A: Yes. Since the Commission serves as the surrogate for competition, the ratemaking
11 process should, to the extent possible, attempt to produce the efficiencies obtained in a
12 truly competitive market. In a competitive market, though, a firm is able to increase its
13 prices merely because its costs are rising. Prices in a competitive market increase when
14 the costs of all producers increase. For example, when the costs of all producers in an
15 industry rise due to inflation, overall prices in that industry will eventually increase as
16 well.

17 **Q: Was there a time when attrition adjustments were common for regulated utilities?**

18 A: In the 1980s, attrition adjustments were more common because of the exceedingly high
19 annual inflation rates experienced at that time across the country. Due to the unavoidable
20 rising costs of providing service, some utilities were granted attrition adjustments to
21 counterbalance these inflationary cost increases. That is not the case today, though.
22 Instead, we have experienced very low rates of inflation for many years now (see Table
23 5, below). In my experience, attrition adjustments are an artifact of the past. In fact, the

1 last attrition adjustment I saw was in a 1991 Oklahoma rate case. It was soundly rejected.
2 Additionally, I understand that the Washington Commission has recently considered
3 attrition adjustments.

4 **Q: What have the inflation trends been over the last several years?**

5 A: The following table provides the annual rates of inflation as measured by the Producer
6 Price Index (PPI) and Consumer Price Index (CPI) over the last several years:

Table 5 - Annual Inflation Rates[28]

Year	PPI	CPI
2016	1.6%	2.1%
2015	-1.1%	0.7%
2014	0.9%	0.8%
2013	1.2%	1.5%
2012	1.9%	1.7%
2011	3.2%	3.0%
2010	2.8%	1.5%
2009	N/A	2.7%
2008	N/A	0.1%
2007	N/A	4.1%

7 As shown in the table above, inflation is far below the level at which attrition adjustments
8 should occur for ongoing cost increases in the ordinary course of business.

9 VI. SPECIFIC ADJUSTMENTS TO THE REVENUE REQRUIREMENT

10 **Q: What adjustments are you proposing?**

11 A: I do not believe that Avista qualifies for special rate treatment – in effect a projected test
12 year – because the cost projections claimed by the Company are not the kind of increases
13 that are beyond the control of management. As a result, I am making my proposed

[28] United States Department of Labor, Bureau of Labor Statistic, https://www.bls.gov (last visited Oct. 27, 2017).

1 adjustments to the Company's filed Traditional Pro Forma Study, rather than the
2 Company's proposed EOP Rate Base Study. The Company's Traditional Pro Forma
3 Study results in increases in Rate Year 1 of $37.5 million for electric and $4.5 million for
4 natural gas.[29] The Traditional Pro Forma Study is the closest methodology to the
5 Commission's preferred approach. I am proposing very limited adjustments to this study.
6 They include adjustments to: (1) cost of capital, (2) power cost, (3) labor, (4) property
7 taxes and (5) directors' fees.

8 **Q: What adjustment are you proposing to cost of capital?**

9 A: The recommendations regarding cost of capital are contained in the testimony Mr. David
10 Garrett.[30] He recommends a return on equity (ROE) of 9.0 percent and a capital structure
11 with 48.5 percent equity. I have incorporated his recommended ROE in Public Counsel's
12 revenue requirement schedules.

13 **Q: What adjustment are you proposing to power costs?**

14 A: My adjustment simply reverses Avista's proposed increase for power costs, based on Ms.
15 Rachel Wilson's analysis. In her response testimony, Exhibit RSW-1CT, Ms. Wilson
16 recommends disallowing the Company's requested power cost increase. Any increases in
17 power costs should be withheld until Avista provides modeling that follows industry best
18 practices and reconciles previous forecasts to actual costs. See Ms. Wilson's testimony
19 and exhibits for additional detail.

20 **Q: What adjustment are you proposing for payroll costs?**

21 A: Avsita's proposed payroll costs adjustment projects payroll cost increases through 2018.
22 This goes too far beyond the 2016 test year cut off. A modified test year approach allows

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[29] Andrews, Exh. EMA-1T at.7: 13-21.
[30] *See* Response Testimony of David J. Garrett, Exh. DJG-1T.

1 adjustments for *known and measurable changes* occurring during the test year or shortly
2 thereafter. Projected costs, however, two years beyond the end of the test year would not
3 be allowed under this approach. My adjustment reverses one-half of the Company's
4 proposed increase for payroll costs. This adjustment is intended to effectively allow the
5 requested increase for 2017 but not the increase for 2018. This helps synchronize payroll
6 costs with plant additions. Since the Company's AMA *pro forma* study includes plant
7 additions through 2017, for additions greater than .5 percent of rate base, my adjustment
8 allows the payroll cost increases over this same period.

9 **Q: What adjustment are you proposing to property tax expense?**

10 A: The Company's proposed property tax adjustment, like its payroll adjustment, projects
11 property tax increase through 2018. My adjustment reverses one-half of the Company's
12 proposed increase. Again, though not perfect, this adjustment effectively allows an
13 increase for 2017 but not an increase for 2018. This attempts to synchronize property tax
14 with plant additions. Since the Company's AMA *pro forma* study includes plant
15 additions through 2017, for those additions greater than .5 percent of rate base, my
16 adjustment allows the property tax cost increases over this same period.

17 **Q: What adjustment are you proposing to Director Fees expense?**

18 A: My adjustment removes Directors' Fees from *pro forma* expense. Directors' Fees are
19 generally considered a shareholder expense rather than a ratepayers' expense. I agree
20 with this treatment. Directors of any corporation have a legal, fiduciary duty to put the
21 interests of the corporation first. This means that these individuals are required to put the
22 interests of the company above the interest of the customers. Undoubtedly, the interests
23 of the company and the interests of the customer are not always the same, and at times,

1 can be quite divergent. This natural divergence of interests creates a situation where not
2 every cost associated with executive compensation is presumed to be a necessary cost of
3 providing utility service. Many regulators are inclined to exclude executive bonuses,
4 stock-based incentive pay, supplemental retirement benefits and directors' fees from
5 utility rates, understanding that these costs would be better borne by shareholders.

6 **Q: What is the overall impact of your proposed adjustments to the Company's pro**
7 **forma study?**

8 A: The impact of our proposed adjustments are set forth in Table 6 below.

Table 6 – Revenue Requirement Impact of Public Counsel's Recommendations (000's)				
Description	**Avista ProForma (Electric)**	**Public Counsel (Electric)**	**Avista ProForma (Gas)**	**Public Counsel (Gas)**
Adjusted Rate Base	$1,472,291	$1,472,291	$ 305,913	$ 305,913
Rate of Return	7.69%	7.26%	7.69%	7.26%
Net Operating Income Requirement	113,219	106,888	23,525	22,209
Adjusted Net Operating Income	89,991	102,252	20,712	21,221
Net Operating Income Deficiency	23,229	4,637	2,812	988
Revenue Conversion Factor	0.61941	0.61941	0.62065	0.62065
Revenue Requirement Increase	37,501	7,486	4,531	1,592
Net Impact of PC Recommendations		(30,015)		(2,939)

9 **Q: Does this conclude your testimony at this time?**

10 A: Yes, it does.