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VIA: Electronic Mail

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

Re: Reply Comments of Avista Utilities - Docket No. U-100522

Dear Mr. Danner,

Avista appreciates the opportunity to submit reply comments in the above-cited docket. After having read all of the comments submitted in this Docket, the Company believes it is important that the Commission make a determination in this proceeding on at least four fundamental questions. First, does a utility experience a reduction in the recovery of its fixed costs of providing service to customers as a direct result of successful implementation of energy efficiency programs? Second, should some adjustment be made in current ratemaking practice to restore recovery of these fixed costs? Third, should some form of incentive be provided to utilities to achieve energy efficiency savings over and above the level required by the Energy Independence Act (EIA)? And fourth, is it appropriate to allow utilities to finance and capitalize all or a portion of the energy efficiency costs, and recover the costs over a period of time rather than in the first year?

Reduction in Fixed Cost Recovery (Lost Margin) Related to Energy Efficiency

Most of the comments submitted by the Parties in this Docket acknowledge that reduced kWh or therm usage by customers as a result of energy efficiency results in reduced recovery of fixed costs. We believe that it is very clear under current ratemaking practices that this reduction of

fixed cost recovery does in fact occur. In a general rate case the fixed costs of providing service to customers that are determined to be prudently incurred are spread to historical test period loads. Following the test year, to the extent that customers take action to use less energy, a portion of these prudently incurred fixed costs are not recovered because of the reduced kWh sales or reduced therm sales, all other things being equal. We recognize that other changes in revenues and expenses also occur following the test year, and these changes should be taken into consideration when developing the solution to post-test year recovery of fixed costs related to energy efficiency savings.

Adjustment to Restore Recovery of Fixed Costs

An adjustment should be made, whether in the form of a pro forma adjustment in a rate case or some type of mechanism such as decoupling, to restore recovery of the fixed costs. The rates established by the Commission in a general rate case are designed to provide recovery of all prudently incurred costs, and the opportunity for shareholders to earn a fair return determined by the Commission. However, this cost recovery does not occur because of the requirement to achieve energy efficiency. As stated above, in a general rate case the fixed costs of providing service to customers are spread to historical test period loads in establishing retail rates. Under the EIA utilities are required by law to achieve measurable, reduced energy sales. Therefore, in the year following the test period when new retail rates are in effect from the general rate case, retail loads will be lower as a result of the required energy efficiency, and some of the Company's fixed costs will not be recovered.

The "matching principle" and "known and measurable" pro forma adjustments have been addressed extensively in the last couple of general rate cases before the Commission. The reduction in load resulting from the required energy efficiency is a "known and measurable" event. The energy savings are required by law, and utilities must quantify and report to the Commission the measured minimum required level of savings using protocols acceptable to the Commission. Unless there is some adjustment in the rate case, or through some other mechanism such as decoupling, related to the requirement to reduce load through energy efficiency, then there will not be a proper matching of revenues and expenses, i.e., revenues and expenses will not match because the Company is required by law to reduce its revenues through energy efficiency. In order for revenues and expenses to be properly matched for ratemaking purposes, it is necessary to make some kind of adjustment for the known reduction in energy sales that will occur, otherwise the matching principle is violated.

Some parties have commented to the effect that utilities are required under the law to achieve energy efficiency under the EIA, and therefore, no lost margin recovery or incentives are necessary. However, unless some form of lost margin recovery is provided, the retail rates established by the Commission in a general rate case would not be "sufficient" to recover the Company's costs. Therefore, absent the provision for lost margin recovery, there would be a conflict between the legal requirement to establish rates that are "just, reasonable or sufficient," (RCW 80.28.020), and the requirement for the Company to achieve the energy savings – a mismatch for ratemaking purposes. The legal requirements of both the EIA and RCW 80.28.020 must be satisfied.

On page 1 of ICNU's comments, it states that "Decoupling is not necessary to encourage Washington utilities to invest in conservation," because the utilities "have historically met or exceeded their proportionate share of regional conservation goals . . ." Avista has aggressively pursued energy efficiency despite the absence of a ratemaking provision for recovery of lost margins associated with energy efficiency. We have done so with the expectation that, at some point, ratemaking practices will be adjusted to provided recovery of these costs. The increased importance and emphasis of energy efficiency today and to the future, which results in significantly higher costs and financial impacts, makes it imperative that ratemaking practice be adjusted now to provide recovery of these costs. Continuing to run aggressive energy efficiency programs without cost recovery is not sustainable. Whether the impacts are large or small, all costs associated with energy efficiency should be recovered so that the disincentive to do energy efficiency is removed, and ratemaking practice is aligned with state policy to promote energy efficiency.

Implementation of a mechanism, such as decoupling, to address recovery of lost margins should not be conditioned upon a provision that the utility do more energy efficiency than in prior years. The mechanism or adjustment should correct the current ratemaking practice that does not provide recovery of these fixed costs, irrespective of the amount of energy efficiency achieved.

Incentives Related to Energy Efficiency Savings

At the outset, as Avista, and other parties, stated in their original comments, it is important to distinguish between 1) recovery of costs related to energy efficiency, and 2) the provision of incentives. A pro forma adjustment or other mechanism to provide recovery of fixed costs (lost margins) related to energy efficiency does not represent an incentive to utilities. It represents recovery of fixed costs that would otherwise occur absent energy efficiency savings. It represents a correction to current ratemaking practice that does not provide recovery of these prudently incurred

fixed costs. It represents removal of a disincentive to do energy efficiency, but does not provide an incentive.

As the Commission considers some method of addressing the recovery of fixed costs related to energy efficiency, and possible changes in the accounting treatment of energy efficiency measures (e.g., charging customers the full cost of the measures in the first year, versus capitalizing and recovering the costs over the life of the measure), it would be appropriate to also consider the adoption of incentives to encourage utilities to pursue energy efficiency savings over and above the targets established under the provisions of the EIA.

Capitalize All or a Portion of Energy Efficiency Costs

The Commission should consider on a utility-by-utility basis whether it is appropriate to capitalize all or a portion of energy efficiency costs, and provide recovery of these costs over time rather than in one year. The energy efficiency measures provide benefits over multiple years, therefore there is a sound basis to spread recovery of the costs of the measures over, for example, the average life of the measures. In fact, this is how energy efficiency costs were accounted for in the years prior to adoption of the current Tariff Rider Surcharge which began in 1995. Under the Tariff Rider, the full cost of funding energy efficiency measures is essentially recovered in the first year.

Capitalizing energy efficiency costs would also make energy efficiency programs more comparable with utility investment in generating resources. The costs associated with owned generating resources are capitalized and depreciated over the life of the resource. Capitalizing and amortizing the cost of energy efficiency over the life of the measures would make investment in the energy efficiency resource comparable, by providing the investor an opportunity to earn a return on the energy efficiency resource, similar to that of a generating resource.

In comments provided by Public Counsel and ICNU, they point out that utilities have not "made use of the rate of return incentive provided for in RCW 80.28.025." (PC page 33) Avista has not "made use" of this provision, at least in part, because since 1995 we have not been capitalizing energy efficiency costs, and there is no ongoing investment upon which to add the incentive rate of return. Therefore, the lack of use of this provision in recent years should not be viewed in any way an indication that changes in cost recovery and incentives related to energy efficiency are unnecessary at this time.

Other Reply Comments

1. Shift of Risk

A number of parties expressed concern that decoupling or other forms of lost margin recovery would shift risk from the utility to customers (e.g., ICNU p. 3, PC p. 41). This is simply not the case. In recent years energy efficiency has ramped up causing more energy savings and a corresponding increase in the amount of prudently incurred fixed costs that are not recovered from customers. Because of the increased focus on energy efficiency it is necessary to address lost margin recovery to preserve the prior balance of risk between shareholders and customers. In fact, the increased success of utilities in achieving energy efficiency has shifted risk in just the opposite way -- from customers to shareholders. Because so much more energy efficiency is being achieved today than in prior years, the return on equity (ROE) should be adjusted upward in the absence of lost margin recovery, because the utility is now not recovering a higher level of fixed costs that it had been recovering in the past.

On page 13 of Public Counsel's comments, in their discussion of incentives, they state that "Classic decoupling only gets the utility to 'neutrality' rather than to motivated behavior." It is interesting that although Public Counsel is opposed to decoupling, they apparently acknowledge here that lost margin recovery through decoupling restores cost recovery to a "neutral" point, and does not provide an incentive.

2. Single Issue Ratemaking

On page 3 of their comments, Public Counsel expressed concerns that lost margin recovery may represent single-issue ratemaking. Lost margin recovery is not single-issue ratemaking. As explained earlier, when base rates are set in a general rate case, there is actually a failure to properly match revenues and expenses, because the required, known decline in sales revenues resulting from energy efficiency is not included in setting retail rates. Providing lost margin recovery provides a proper matching of revenues and expenses for ratemaking purposes, based on a known legal requirement to acquire a minimum level of energy efficiency savings. It is understood that there will be other changes in revenues and expenses that will occur after retail rates are set in a general rate case. Failure to provide ratemaking treatment of a known, required decline of sales revenue results in a mismatch of revenues and expenses for ratemaking purposes.

3. Shortfall in Cost Recovery

On page 5 of Public Counsel's comments, they cite an average return on equity for natural gas utilities in general of 12 percent, and indicate that there is "no evidence of a shortfall in cost recovery." This Docket is intended to address cost recovery in the State of Washington, and not in other parts of the country. For Avista, our actual return on equity in Washington for electric operations was 7.15% in 2007, 7.18% in 2008, and 7.20% in 2009. The actual ROE for Washington natural gas operations was 7.30% in 2007, 7.44% in 2008, and 6.66% in 2009. All of these returns are well below the Commission-authorized ROE of over 10% for these years. Therefore, the absence of lost margin recovery related to energy efficiency represents a compounding of the under-recovery of costs to serve customers in the State of Washington.

4. Annual General Rate Cases

On page 13 Public Counsel states that "These nearly annual filings by definition allow the utility to request relief for any failure to earn a reasonable return, and to receive a rate increase if needed to remedy the problem." The primary point to the whole discussion around lost margins caused by energy efficiency is that the current ratemaking practices do not account for the reduction in sales that will occur. Therefore, if we continue to set rates the same way every year, and exclude recovery of lost margins related to energy efficiency, another filing will do nothing to address the under-recovery of costs.

5. Utility Cost Control

Some parties suggested that decoupling would provide a disincentive to utilities to control costs (ICNU p. 10). We do not agree. Once retail rates are established by the Commission, it is up to the Company to manage its costs. If a utility is able to lower its actual costs between rate cases, it results in higher actual returns for shareholders. If the lower costs persist over time, then customers will receive the benefit of these lower costs in the next rate case. This equation is true with or without decoupling, therefore, the utility clearly has an incentive to control its costs. NWIGU recognized this in their comments on page 14, "Between rate cases, a utility always has an incentive to control distribution system costs because any gains go directly to the shareholders."

NWIGU goes on to suggest, however, beginning at page 10 of their comments, that LDCs should be provided further incentives to operate efficiently, by adopting an incentive structure for gas commodity prudency decisions similar to that employed in Oregon, in lieu of a conservation

incentive. This misses the crux of the dispute - namely, how does implementation of energy efficiency programs affect recovery of prudently-incurred fixed costs and the realization of Commission-approved margins. These "fixed" costs have nothing to do with variable gas purchasing costs.

6. Utility Management and Customer Service

On page 6 of their comments, ICNU quotes Standard & Poor's (S&P) as follows: "Decoupling's guaranteed level of distribution revenue, regardless of actual performance, may promote mediocrity in the management of a utility and cause a decline in customer service." ICNU, however, failed to provide the context for this quote. The introductory paragraph to this S&P bullet point quoted by ICNU states as follows: "Decoupling allows utilities to project cash flow more accurately and avoid much of the earnings volatility from changes to weather/economy under traditional rate mechanism." (emphasis added) Discussions in this Docket to date have focused primarily on addressing recovery of lost margins related to energy efficiency, and not changes in margins related to weather and the economy. If the WUTC were to entertain a decoupling mechanism that provides a "guaranteed level of distribution margin" that covered energy efficiency, weather, the economy, etc., and if one were to believe that S&P's comment has merit, then it may be appropriate to further consider this issue. Otherwise, the lost margin recovery discussed thus far in this Docket, through decoupling or other means, would have no negative effect on management of the utility or customer service.

7. Lost Margins Related to Energy Efficiency Information and Education

Some parties expressed concerns regarding recovery of lost margins related to energy efficiency information and education provided to customers by the utility, as well as utility support of other regional programs. Costs are incurred to provide information and education to customers related to energy efficiency, as well as to support regional energy efficiency efforts. These costs are incurred because we, and others in the region, believe that these efforts result in customers taking action to conserve energy and use energy more efficiently. If we did not believe this to be true, we, and others in the region, should stop these efforts. Although it is more difficult to quantify the energy savings associated with these efforts, it can be done. Recovery of lost margins related to these energy efficiency efforts is fully consistent with aligning ratemaking practices with state policy to promote energy efficiency.

8. Third-Party Implementation of Energy Efficiency

Some parties have suggested that the Commission consider requiring utilities to have energy efficiency programs delivered by a third-party, instead of the utility. While this may in some ways seem attractive on the surface, and leaving aside concerns over how administratively efficient this would be, it would not resolve the lost margin issue in this Docket, and may also have some unintended outcomes. With regard to lost margins, irrespective of whether the utility or a third-party is achieving energy efficiency savings, it would still result in a reduction of revenues to cover fixed costs, and some form of lost margin recovery would still be necessary.

Regarding potential unintended outcomes, the presence of the energy efficiency programs within the utility reduces any tendency that may exist to increase sales. If energy efficiency were provided by a third-party and the utility's responsibility were to produce/acquire and sell kWh's and therms, and profits are based on sales, it may result in an increased tendency to increase sales.

Avista looks forward to participating in the upcoming work session on June 29th. If you have any questions regarding these issues, please contact Linda Gervais, Manager, Regulatory Policy at 509-495-4975 or myself at 509-495-4267.

Sincerely,

Kelly Norwood
Vice President, State and Federal Regulation
Avista Corporation