BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES Respondent.	DOCKET UE-090134 DOCKET UG-090135 (consolidated)

BRIEF OF COMMISSION STAFF

November 10, 2009

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I. INTRODUCTION

1 Avista Corporation ("Avista") filed this consolidated general rate case (Dockets UE-090134 and UG-090135) with the Commission, originally seeking a $69.8 million, or 16.0 percent, rate increase for electric service, and a $4.9 million, or 2.4 percent, rate increase for natural gas service. Subsequently, the Commission consolidated Docket UG-060518, regarding the Company's pilot decoupling mechanism, together with the rate case. On September 4, 2009, all parties to the rate case entered into a Partial Settlement Stipulation, addressing cost of capital, power supply, rate spread, rate design, and low-income ratepayer assistance. As a result of the partial settlement, the Company now seeks rate increases of $37.5 million for electric service, and $2.8 million for natural gas service.

2 Staff has thoroughly reviewed Avista's filings, and continues to contest many issues related to Avista's claimed electric and gas revenue requirements, including adjustments for capital additions, asset management, information services, compensation and incentives, and several other items. Staff's adjustments lower Avista's revenue requirements to $24.2 million for electric service, and $634,000 for natural gas service. Staff also recommends that the Commission reject Avista's request to address its Energy Recovery Mechanism ("ERM") in this rate case.

3 Finally, Staff recommends that the Commission phase out Avista's pilot decoupling mechanism, so that the program will end effective January 1, 2011. Staff also recommends that the Commission raise the customer basic charge to $8.00 on January 1, 2010, and to $10.00 on January 1, 2011; and that the Commission lower Avista's usage charges. Avista has not demonstrated that decoupling has encouraged it to increase its investment in conservation. Staff's alternative rate design will promote rate stability and encourage conservation, with far less administrative burden.

II. PROCEDURAL HISTORY

4 On January 23, 2009, Avista filed tariff revisions with the Commission, seeking a 16.0% increase in electric rates and a 2.4% increase in natural gas rates. The Commission suspended the filings on February 3, 2009, consolidated the two dockets, and following a prehearing conference on February 24, 2009, set the general rate case dockets for hearing in October 2009.

5 On April 30, 2009, Avista filed a petition to consolidate Docket UG-060518, concerning the Company's pilot decoupling mechanism, with the general rate case. The Company also sought to extend the pilot mechanism beyond its scheduled termination date of June 30, 2009. The Commission granted the petition to consolidate, granted Avista's request for an interim extension of the existing mechanism, and directed the parties to address whether Avista's decoupling should be permanently extended, modified, or discontinued, in the general rate case.

6 Following settlement discussions in July and August 2009, the parties reached a Partial Settlement Stipulation resolving issues in the areas of cost of capital, power supply, rate spread and rate design, as well as funding under the low-income ratepayer assistance program. The parties filed the partial settlement with the Commission on September 4, 2009. The parties also filed response testimony on August 17, 2009, and rebuttal and cross-answering testimony on September 11, 2009. Two public hearings were held in the Spokane area on September 30, 2009, and the Commission held evidentiary hearings in Olympia from October 6-9, 2009.

III. THE COMMISSION SHOULD APPROVE THE PARTIAL SETTLEMENT STIPULATION

7 The Partial Settlement Stipulation, filed on September 4, 2009, reaches a reasonable resolution of several issues in this proceeding, is agreed to by all parties to the rate case proceeding,[1] and substantially reduces Avista's revenue requirement. The Settlement helps further both Staff's and the public's interest in fair, just, and reasonable rates.

8 Staff recommends that the Commission approve the partial settlement for several reasons. First, the settlement resolves all cost of capital issues, and provides for a 10.2% return on equity (ROE) with a capital structure containing 46.5% common equity. The 10.2% ROE closely approximates Staff's litigation position of 10.0% (in contrast to the 11.0% contained in the Company's original filing), is within Staff's range of 9.5% and 10.5%, and is the same as the ROE that was approved in the most recent Avista settlement. It is consistent with Staff's position that recent events in the capital markets do not justify an increase in the Company's ROE at this time. The 46.5% common equity ratio is a reasonable compromise between Staff's litigation position of 45.4% (based on Avista's actual 2008 year-end capital structure) and the Company's request for 47.51% (based on Avista's projected 2009 year-end capital structure).

9 Second, the settlement resolves power supply issues in a manner that is very satisfactory to both Staff and the public interest. It substantially reduces the Company's filed power supply costs, by over $27.5 million, and includes several adjustments recommended jointly by Staff and ICNU. The settlement updates natural gas costs to reflect the significant drop in the price of natural gas since the filing of the Company's case, and

[1] The NWEC Energy Coalition, which filed testimony concerning Avista's decoupling mechanism, is not a party to the Partial Settlement, but does not oppose the settlement among all the other parties. Exh. B-1, *Partial Settlement Stipulation,* at 1.

provides certainty to customers by ensuring that there shall be no further changes to the price of natural gas in this case. It also includes the retail load adjustment and filtering adjustment jointly recommend by Staff and ICNU. The settlement also removes $2.4 million of 2010 pro forma costs that were included in the Company's filing for generation operations and maintenance, which benefits ratepayers.

10 Third, the settlement resolves rate spread and rate design issues in a manner very similar to that advocated by Staff witness Ms. Huang. The parties have agreed to apply an equal percentage increase to all electric service schedules, and an equal percentage of margin increase to all gas service schedules except Schedule 146; and to increase the electric residential basic charge from $5.75 to $6.00. Staff believes these provisions are fair and reasonable and further the public interest.

11 Finally, funding for electric low income rate assistance is increased by the greater of the overall percentage increase or 9 percent. Funding for natural gas low income rate assistance is increased by the greater of the overall percentage increase or 1.75 percent. The natural gas program is within the range of other natural gas companies and even though Avista's electric program is a larger percentage of revenue than other electric companies, Staff is supportive of the electric and gas increases to the low income rate assistance programs as a component of the overall settlement package.

IV. ARGUMENT

A. CONTESTED REVENUE REQUIREMENT ADJUSTMENTS

12 Staff contests many adjustments pertaining to the Company's claimed revenue requirement for electric and natural gas service. Each of these contested adjustments is set forth below.

1. Non-Executive Compensation Expenses

13 Avista proposes three adjustments for non-executive compensation expenses. First, Avista normalized test year wages for an increase in wages that was effective in 2008. Second, the Company adjusted for 2009 wage increases that were approved by Avista's board of directors and negotiated by the unions. Third, Avista adjusted for wage increases that it anticipates will occur in 2010. Staff does not contest either of the first two adjustments. The proposal to normalize 2008 wages is correctly applied, as is annualization of the negotiated 2009 wages. However, Staff recommends that the Commission deny the proposed adjustment for anticipated 2010 wage increases.[2]

14 WAC 480-07-510 specifies that proper pro forma adjustments give effect for the test period to *all known and measurable changes* that are not offset by other factors. Pro forma adjustments, in other words, are not merely "estimates," based on the Company's "judgment," which are simply added to test year results.[3] However, the Company's testimony indicates that its proposed changes for 2010 wages are simply that: mere estimates, and moreover, estimates that have changed even during the pendency of this rate case. Ms. Andrews's direct testimony, filed in March 2009, pro formed in the salary increases that were then "expected" to be 3.8% on March 1, 2010, for administrative and union employees. In her rebuttal testimony, however, she revised this expected amount downward, to 2.8% for administrative employees, and also lowered the originally estimated amount for union employees.[4]

15 During cross-examination, Ms. Andrews confirmed that these increases still have not yet been approved by Avista's board of directors; that Avista has not represented to its

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[2] LaRue, Exh. AMCL-1T at 5-6.
[3] *Id.* at 6.
[4] Andrews, Exh. EMA-4TC at 6-7.

employees that it has agreed to make these increases; and that Avista is not yet obligated under any contractual basis to pay these wage increases in 2010.[5] In fact, negotiations have not yet been completed for the upcoming union contract.[6]

16 In sum, pro forma adjustments are not proper for estimated, non-obligated increases that are merely projected to occur in 2010. The Commission should, therefore, reject the Company's proposed adjustment and accept the adjustment proposed by Staff (i.e., for years 2008-2009 only), which increases Avista's overall revenue requirement by $1,816,265 for electric operations and $477,809 for natural gas operations.[7] The net difference between Avista's and Staff's recommendations is -$679,000 for electric operations and -$175,000 for gas operations.[8]

2. Executive Compensation Expenses

17 Avista proposes two adjustments for executive compensation expenses. First, the Company removed the effect of 2008 compensation. Second, the Company adjusted test year compensation for salary increases expected in 2010. No adjustment was made for 2009, as no executive salary increases were approved for that year. Staff agrees that the Company's 2008 adjustment is proper. However, Staff recommends that the Commission deny the Company's proposed adjustment for expected 2010 increases.

18 As with the non-executive wage increases, these "expected" amounts are simply Company estimates that are subject to change. They have changed during the pendency of this case (from 3.8% to 2.8%). They are speculative, based on the results of a market study

[5] Tr. 591-592 (Andrews).
[6] Andrews, Exh. EMA-1T at 7.
[7] Larue, Exh. AMCL-1T at 7.
[8] Staff's Response to Bench Request 2, Exh. DPK-2 and DPK-3 (Summary of Adjustments), revised October 5, 2009 and November 6, 2009.

of several companies, one of which is Avista.[9] But the study itself is "preliminary" at this time.[10] And again, Avista is not yet contractually obligated to pay any of these salary increases, nor has its board of directors approved them. These estimates are not yet known and measurable, and are not proper pro forma expenses.

19 The Commission should reject the Company's proposed adjustment and accept Staff's recommended adjustment (i.e., for year 2008 only), which increases Avista's electric revenue requirement by $158,019, and its natural gas revenue requirement by $42,695.[11] The net difference between Avista's and Staff's recommendations is -$40,000 for electric operations and -$12,000 for gas operations.[12]

3. Incentives

20 Avista proposes three adjustments for incentive compensation. First, the Company adjusts 2008 incentives paid to the actual amounts paid. Second, the Company proposes using a six-year average to normalize the incentives paid. Finally, Avista uses the Consumer Price Index ("CPI") to further adjust these amounts. Staff objects to the latter two adjustments proposed by the Company and recommends that they be rejected.

21 The use of a six-year average to "normalize" incentives is not warranted for the simple reason that the Company has made no showing that what it actually paid as incentives in 2008 is somehow not "normal" or representative. That is the only reason why one may make adjustments to actual test year results. One look at Table 2 at the top of Ms. Andrews's rebuttal testimony demonstrates that the clear effect of any suggestion to average

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[9] To the extent that Avista provides information for this market study and then uses the result of this same study to generate "expected" increases for Avista's future compensation expenses, the results are to some extent circular.
[10] Andrews, Exh. EMA-4T at 7.
[11] Larue, Exh. AMCL-1T at 9.
[12] Staff's Response to Bench Request 2, Exh. DPK-2 and DPK-3 (Summary of Adjustments), revised October 5, 2009, and November 6, 2009.

incentive payments to the amounts paid from 2003-2008 will be to raise the amount that the Company recovers from ratepayers, since the amount paid out in 2008 ($2.8 million) is the *lowest* amount of any of those six years. Yet there is also a clear, steady downward *trend* in the past four years, from a high of $6.1 million in 2005, to $4.7 million in 2006, to $3.4 million in 2007, to $2.8 million in 2008. Moreover, as Mr. Larkin pointed out, given the country's economic situation, it is unlikely that incentive expense will increase to the Company's projected level.[13]

22 Avista protests that Staff recommended the use of an eight-year average in one of the Company's prior rate cases to determine the normal level of incentives. That is true, but as Exh. EMA-9X clearly demonstrates, the situations then and now are markedly different.[14] From 1999-2006, the level of incentives that Avista paid out was extremely volatile, jumping up and down from year to year throughout the entire period, with two years in which the Company chose to provide *no incentive pay.* One of those years, 2001, was a time of economic downturn, similar to 2008. There was no trend, and certainly no indication then that the high amount paid out in 2006 (the test year in that case) was representative as a forward-going number—and indeed, we have since seen that the amounts since then have gone steadily lower. In summary, Avista's proposal to use a six-year average for incentives is not warranted.

23 Nor is the use of the CPI justified as an adjustment to incentives. The way in which Avista constructs its incentive programs, the triggers it chooses to use, and ultimately the amounts it determines to pay are all entirely within the discretion of the Company. Indeed, the Company itself says that it decided to restructure its incentive program in 2002, when it

[13] Larkin, Exh. HL-1T at 20.
[14] Exh. EMA-9X is Avista's supplemental response to Staff Data Request 232 in Dockets UE-070804/UG-070805. The amounts paid out from 1999-2006 are shown in the Table at the bottom of page 1 of the exhibit.

first offered the current version of the program.[15] The amounts paid are not based on or dependent upon an index of any kind. As Ms. LaRue points out, using an inflation factor is not appropriate for determining rate year levels, since the CPI is not an indicator of what the Company will pay in incentives during the rate year.[16]

24 The Commission, therefore, should reject the Company's proposed adjustment for incentives and accept the adjustment proposed by Staff. This decreases Avista's electric revenue requirement by $18,202 and decreases its natural gas revenue requirement by $5,029. The net difference between Staff's and Avista's recommendations is -$592,000 for Avista's electric operations and -$164,000 for its gas operations.

4. Directors' and Officers' ("D&O") Insurance

25 Avista contends that the ratepayers should be required to pay 100% of the allocated costs incurred in purchasing D&O liability insurance.[17] D&O insurance protects corporate directors and officers when lawsuits are brought against them while performing their corporate duties. While acknowledging this fact, Avista simply states that the Company would be unable to attract or retain capable individuals for the board of directors, or to otherwise serve as officers, if it did not purchase D&O insurance. Thus, according to Avista, it is "an essential part of the operation of a utility" that ratepayers should wholly fund.[18]

26 This argument, however, ignores the fact that the majority of lawsuits brought against corporations are initiated by shareholders, not ratepayers. Ms. LaRue pointed this

[15] Andrews, Exh. EMA-4T at 17.
[16] Larue, Exh. AMCL-1T at 11.
[17] Avista allocated 97.5% of the total cost of 2009 D&O premiums to its utility operations. Andrews, Exh. EMA-4T at 27-28.
[18] *Id.*

out in response to questioning from Commissioner Oshie,[19] and it has been confirmed by other utility commissions. *See Re Connecticut Light and Power Co.,* 124 P.U.R. 4th 532, 560 (Conn. D.P.U.C.) (1991) ("Given the fact that the majority of the lawsuits would be initiated by shareholders, the Authority [Commission] agrees . . . that the costs should be borne equally between shareholders and ratepayers."); *Re CenterPoint Arkla, a Division of CenterPoint Energy Resources Corp.,* 245 P.U.R. 4th 384, 409 (Ark. P.S.C.) (2005) ("The news is replete with stories about companies experiencing lawsuits by shareholders. The Commission agrees with AG that more often than not it is the current shareholders who sue management and who receive a large portion of the proceeds from the D&O insurance payouts.") Moreover, the Connecticut commission has more recently noted that while it historically has allowed a portion of D&O insurance to be charged in rates, to assure some level of ratepayer protection from catastrophic lawsuits, the commission "agrees with the OCC [Office of Consumer Counsel] that the shareholders should bear the weight of their decisions in appointing directors (who appoint the officers of the Company)."

27 Accordingly, the California[20] and Arkansas[21] commissions have agreed that the cost of purchasing D&O insurance should be split 50%/50% between shareholders and ratepayers. Connecticut formerly adhered to this view; more recently, however, it held that shareholders should pay *75%* of these costs, and ratepayers only 25%.[22] In light of the benefits that accrue to both shareholders and ratepayers, Staff's recommendation of a 50%/50% split is clearly reasonable and should be adopted by the Commission.

28 The result of Staff's recommended adjustment decreases Avista's electric revenue requirement by $147,000, and its natural gas revenue requirement by $41,000. The net

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[19] Tr. 682-683 (LaRue).
[20] *Re Southern California Edison Company,*64 C.P.U.C. 2d. 241, 1996 WL 33178 (Cal P.U.C. 1996).
[21] *Re CenterPoint Arkla, supra.*
[22] *Re The United Illuminating Co.,*246 P.U.R. 4th 357 (Conn. D.P.U.C. 2006).

difference between Staff's and Avista's recommendations is -$376,000 for Avista's electric operations and -$103,000 for its natural gas operations.[23]

5. Board of Directors Meetings

29 Avista proposes that ratepayers fund all of the costs of Board of Directors meetings. Avista's rationale is simply that this is "a necessary expense of doing business." Staff recognizes that these meetings serve ratepayers' interests, in part. However, since Avista's Board of Directors is elected by shareholders with the purpose of overseeing and enhancing the corporate value of Avista, these meetings obviously serve shareholders' interests as well.[24]

30 Testimony and exhibits referenced during cross-examination further confirm this fact. When asked if directors perform some duties and address issues "that are related to their own interests as well as those of the shareholders and non-utility subsidiaries and affiliates?" Ms. Andrews answered "Yes, that would be true."[25] The minutes from a recent board meeting further show that the Board of Directors was provided a directors scholarship update, considered a dividend declaration, and received a portfolio strategies presentation and a subsidiary update. This reflects that the directors do, indeed, perform duties related to their own interests as well as those of the shareholders.[26] Avista's response to a Staff data request also itemized all costs in the test year related to Board of Directors meetings. These costs included dinners at hotels and wine cellars, a catered lunch, museum tickets for directors, a playhouse performance, and a cruise on Lake Coeur d'Alene. Clearly, these

[23] Staff's Response to Bench Request 2, Exh. DPK-2 and DPK-3 (Summary of Adjustments), revised October 5, 2009, and November 6, 2009.
[24] Kermode, Exh. DPK-1T at 20.
[25] Tr. 568 (Andrews).
[26] Andrews, Exh. EMA-16XC; Tr. 567-568.

types of costs should be borne by shareholders, not ratepayers, as they are not necessary to provide service to ratepayers.[27]

31 The Company suggests in rebuttal testimony that, at most, shareholders should pay only 10% of Board meeting expenses, with the other 90% allocated to ratepayers. It provides no support for this recommendation, other than to state that "this is the average split utilized by the Company for officer compensation."[28] Staff's recommendation for a 50%-50% split of board of meetings expenses is consistent with the evidence that these expenses serve both shareholders' and ratepayers' interests, and should be adopted. This adjustment reduces the Company's electric revenue requirement by $24,000 and its natural gas revenue requirement by $6,000.[29]

6. Customer Deposits Adjustment

32 Staff recommends that Avista's rate base be reduced by the average-of-monthly-average balance of customer deposits, and that the test year associated interest expense be recognized as an above-the-line item for ratemaking purposes. This adjustment recognizes that a portion of Avista's rate base is funded by customer deposits, which cost less than the Company's overall cost of capital. It also recognizes that the interest paid by the Company on deposits should be borne by the general body of customers that benefit from the rate base reduction.[30] The interest rate for 2009 is 0.42%, which is based on the one-year Treasury Constant Maturity calculated by the U.S. Treasury, as published on January 15 of each year.[31]

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[27] Andrews, Exh. EMA-17X; Tr. 570-574.
[28] Andrews, Exh. EMA-4T at 33.
[29] Staff's Response to Bench Request 2, Exh. DPK-2 and DPK-3 (Summary of Adjustments), revised October 5, 2009, and November 6, 2009.
[30] Kermode, Exh. DPK-1T at 17-18.
[31] The rate is set pursuant to WAC 480-100-113(9) and WAC 480-100-118(6) for electric residential and non-residential customers, and pursuant to WAC 480-90-113(9) and WAC 480-118(6) for natural gas residential and non-residential customers.

33 Avista urges the Commission to reject Staff's adjustment for customer deposits, arguing that the $2.5 million in customer deposits is simply a means of managing the costs associated with uncollectible accounts receivable.[32] The Company fails to provide any support for its implied claim that the full $2.5 million of ratepayers' money is somehow fully committed in the "managing" of costs. In fact, Avista clearly points out that the money is held by the Company as security and "automatically returned" to customers after 12 months of satisfactory payment risk, highlighting the fact that the Company has free use of those funds for that time.[33] As testified to by Mr. Kermode, the $2.5 million in customer deposits is the average of monthly average balance, which reflects the rotating nature of this account.[34] As payments are returned to old customers, new deposits are received from new customers.

34 Further, the Company makes no claim that it keeps deposit money in a separate secured account. Rather, it is undisputed that the deposit money provided by its ratepayers is a source of funds that the Company free to use, for the benefit of the rate payers. Although the Company is free to use the funds for anything, Staff assumes for the purpose of ratemaking that the highest and best use for the benefit of the rate payers is the financing rate base.[35] At the same time, the Company is made whole by the inclusion of the cost of the deposits in its revenue requirement.

35 Staff's adjustment is fair to both customers and the Company. Customers get credited for the cheaper funds available for Avista's use, and the direct rate base deduction simply recognizes the Company's ability to invest the customer-provided funds and assures

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[32] Andrews, Exh. EMA-4T at 36.
[33] Andrews, Exh. EMA-4T at 36.
[34] Kermode, Exh. DPK-1T at 17.
[35] *Id.*, 17.

that customer deposits do not benefit non-utility operations. Avista remains whole by inclusion of the actual interest paid on deposits as an operating expense.

36 The Commission has approved this adjustment in several previous cases. It has been a standard uncontested adjustment in Puget Sound Energy cases over the last 25 years, as well as in a recent PacifiCorp case.[36]

37 The result of Staff's customer deposits adjustment decreases Avista's electric revenue requirement by $317,000, and decreases Avista's natural gas revenue requirement by $173,000.[37]

7. Pro forma Production Property Adjustment

38 In its filing, Avista uses a new approach for the computation of the production property adjustment. Its new approach, however, fails to match properly the pro forma plant additions and production/transmission related expenses to the test year.[38] Avista's production property adjustment model fails to recognize (1) the test year's transmission and production plant, and (2) transmission and production related test year expenses.[39] In addition, the Company uses two load factors, one for its 2009 pro forma adjustments, and a second for its 2010 pro forma adjustments.[40] Clearly, this new method fails to provide proper matching of the Company's pro forma adjustments to the rate year loads, because of its incorrect use of the 2009 load factor.

39 Staff, on the other hand, has provided a production property adjustment that properly uses a production factor that is applied to the rate year production/transmission costs,

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[36] *Id.* at 19; *See, e.g.,* Cause No. U-82-38, Third Supplemental Order at 25 (Table of Uncontested Adjustments, line 19); *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.,* Dockets UE-061546 and UE-060817, Order 08 at 59.
[37] Kermode, Exh. DPK-2 (Summary of Adjustments), revised November 6, 2009.
[38] Kermode, Exh. DPK-1T at 27.
[39] *Id.*
[40] Andrews, Exh. EMA-1T at 22.

bringing the pro formed rate year costs, on a unit basis, back to the historic test year for proper matching and comparability of all costs used in the revenue requirement determination.[41] Company witness Ms. Knox clearly supports Staff's claim in Illustration 1 of her rebuttal testimony.[42] Her table correctly shows that using Staff's method for recovery of test year costs, those costs are recovered, with no additional premium added. Ms. Knox testifies, "When the future rate year occurs, if the expected loads materialize in 2010, the Company would only recover historical test year costs and no more."[43] Staff agrees; this is precisely what a proper adjustment should provide.

40 What Ms Knox argues to be a deficiency, is actually nothing more than standard historical test year rate making. Mr. Kermode testified that "...the dynamic of the production adjustment is to match test year costs with rate period loads, that ... matching takes place at the test year level."[44] As Mr. Kermode stated, "Central to the adjustment is the assumption that the future rate year will have different levels of consumption than the normalized historic test period."[45] However, this does not mean that historical test year amounts should be increased *beyond* what is already supported in separate stand-alone restating or pro forma power and transmission related adjustments. To do this would effectively allow Avista to over-recover its costs.

41 The Company's use of a 2009 load factor fails to match properly pro forma plant additions and production-related expenses with the test year.[46] Accordingly, the Company's production property adjustment should be rejected.

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[41] Kermode, Exh. DPK-1T at 25.
[42] Knox, Exh. TLK-8T at 6.
[43] *Id.*
[44] Tr. 741 (Kermode).
[45] Kermode Exh. DPK-1T at 25.
[46] Kermode, Exh. DPK-1T at 27.

42 Staff's production property adjustment decreases Avista's revenue requirement by $5.47 million.[47] There is no effect on Avista's gas revenue requirement.

8. Pro Forma Capital Additions

a. The Commission's Rules Allow Rate Recovery for Pro Forma Capital Additions Only for Known and Measurable Changes That Are Not Offset by Other Factors. Under a Strict Application of the Pro Forma Principle, Only the Noxon 1 and Noxon 3 Upgrades Qualify for Inclusion as a Pro Forma Adjustment in This Case. However, Staff Has Identified a Limited Number of Other Projects That Are Includable Under a More Liberal Interpretation of the Pro Forma Principle.

43 The Commission asked, at the end of the hearing, what principle should be used to determine when pro forma capital additions should be included in rate base, for recovery in rates, in a general rate case.[48] Staff believes that a strict application of the Commission's rules would allow recovery only in rare instances, such as major generation acquisitions, or major transmission investment related to system reliability, where all offsetting factors are accounted for, as described in Staff witness Mr. Parvinen's testimony. In this case, recovery would be limited to the Noxon #1 and Noxon # 3 upgrades.[49]

44 Staff witness Mr. Kermode has identified a limited number of additional projects that would be allowable under a more liberal interpretation of the pro forma principle, including smaller transmission, distribution, or generation projects that are required by either rule or regulatory requirement, or that are required for system reliability. Significantly, Mr. Kermode's additional pro formed projects include *only* those in service prior to June 30, 2009, as Staff's audit of completed projects concluded on that date.

45 As set forth more fully below, however, and as reflected in the testimony of Mr. Parvinen, Staff believes it possible that not all of the offsetting factors can be identified

[47] Kermode, Exh. DPK-2, revised November 6, 2009.
[48] Tr. 1288.
[49] Kermode, Exh. DPK-1T at 40.

for these smaller projects, without having the benefit of a full test year's worth of data identifying all revenues, expenses, and rate base items, all properly matched. Nevertheless, Staff has identified these projects as pro forma capital additions to rate base, should the Commission choose to apply a more liberal interpretation of the principle. Inclusion of the projects through June 30, 2009, as identified by Mr. Kermode would increase Avista's revenue requirement by approximately $3.8 million.

46 Staff, however, strongly objects to the Company's proposed end-of-year adjustment for all of the 2008 capital projects, and to most of the 2009 capital projects that Avista proposes for pro forma adjustments to rate base. For many of these projects, the costs at issue simply are not known and measurable, but are merely budgeted or estimated. In addition, the Company has not properly included all the offsetting benefits that would result from the projects. Thus, the Company unfairly asks ratepayers to be saddled with all the costs, but does not offer ratepayers the benefits the projects will ultimately generate. The Commission should, accordingly, reject most of the Company's proposed pro forma capital additions.

b. Adherence to the Matching Principle is Essential to Properly Identify Pro Forma Adjustments for Capital Additions.

47 Avista, in this general rate case, essentially proposes to turn ratemaking on its head. Washington has consistently adhered to historical, test-year ratemaking, rather than ratemaking centered upon budgets, estimates, and forecasts of the future. For this reason, the Commission allows pro forma adjustments to test year results *only* for (1) known and measurable changes that (2) are not offset by other factors.[50] However, as Mr. Parvinen has noted, Avista in this case proposes to include "virtually every proposed capital project and

[50] WAC 480-07-510 (3)(E)(III).

budgeted expense" as a pro forma adjustment, as long as the projects or expenses cannot be directly tied to revenues from new customers.[51]

48 At the heart of Staff's concern is a fundamental ratemaking concept, known as the "matching principle." That concept, in turn, is founded upon the use of a test year, with actual, known, revenues and expenses, as a starting point for setting utility rates. The test year consists of a 12-month period of actual results of operations. Mr. Parvinen explains:

> Historical test year ratemaking is premised on the "matching principle" of accounting, where the relationship between revenues, expenses, and rate base is established. For example, if a company has a plant asset at the beginning of the test year, then all of the other components, i.e., test year revenues, expenses, and service levels, reflect that plant asset being in place; and all components—revenues, expenses, and rate base—are properly matched.
>
> However, if the utility were to replace a plant asset during the test year, the replacement asset would have effects on such things as reducing maintenance expense and /or increasing revenues, if the system is made more reliable or expanded. *In most instances, these offsetting factors of the replacement asset will not be fully known until they are embedded in the utility's historical test year results.*[52]

Certain pro forma adjustments will clearly meet the "known and measurable test" of WAC 480-07-510 (3)(e)(iii). Most of these, however do not relate to plant additions, but rather, changes such as an increase in the postage rate on a date certain, or a contractually approved union wage increase. Furthermore, each of these examples do not have offsetting factors. In the case of the postage increase, there will likely be no change in the number of bills the utility mails out. Likewise, the union wage increase will likely not change the number of hours worked by employees. Thus, in each case, the units within the test period are adjusted to the rate year's new known and measurable rate. There is no mismatch of revenues, expenses, or rate base.[53]

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[51] Parvinen, Exh. MPP-1T at 10.
[52] *Id.* at 6-7. (Emphasis added).
[53] Parvinen, Exh. MPP-1T at 5-6.

49 With capital plant additions, however, it is far more difficult to ascertain all of the factors that may offset the expenses incurred. Avista, on rebuttal, makes a belated attempt to "estimate" offsetting factors for its many capital additions on an item-by-item basis. That is, it looks at each addition separately, ignoring the fact that the Company inevitably must view its entire array of revenues, expenditures, and rate base additions as a whole. The critical question that cannot be answered by this piecemeal approach to pro forma additions is, "How did the Company control *other* costs in order to make the additional investment in question, and still attempt to maintain the Company's overall budget?"

50 That question can ultimately be answered only after reviewing an entire test year or rate year's worth of data, with revenues, expenses, and rate base properly matched. Mr. Parvinen's response to Avista Data Request 16 makes precisely this point:

> The test period is chosen in order to have a representative twelve month period where all revenues, expenses, rate base, and services are properly matched. The rate year will create a new snapshot of a twelve month period with different revenues, expenses, rate base, and services, but all matched for that period. *The only way to really know how all the components are matched is after the period has concluded and management has made prudent operating decisions.*[54]

Avista's witness Mr. Norwood suggests the same concept in his rebuttal testimony, in which he says that to analyze the savings associated with capital expenditures, one should "look at the total utility as a whole, which is how ratemaking is done."[55]

51 The fact that capital expenditures on certain items may result in offsetting benefits (e.g., cost reductions, savings) elsewhere in the Company's overall budget is vividly demonstrated by comparing the Company's results of operations from the end of the test period (September 30, 2008) to June 30, 2009.[56] As Mr. DeFelice confirmed in cross-

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[54] Ex. MPP-6X (Staff Response to Avista Data Request 16) (Emphasis added).
[55] Norwood, Exh. KON-1T at 16: 12-15.
[56] Ex. DBD-11X, at pp. 1 and 9.

examination, this exhibit shows that the Company was able to add *over $47 million* to its Washington electric rate base during this nine-month period, and actually *increase* its earnings from 7.308% to 7.397%.[57] This strongly suggests that the Company has been finding ways to control or limit costs elsewhere within its budget to offset its expenditures for capital additions, thus allowing it to simultaneously increase its earnings. Yet, a project-by-project analysis of offsetting factors may not capture these savings. Another example of controlling costs outside the test period that was not reflected in the pro forma analysis was identified by Mr. Norwood, when he pointed out that Avista has recently reduced its employees by 52. These cost-controlling measures once again emphasize the importance of the test year, and the necessity to include all offsetting factors when considering whether to approve proposed pro forma capital additions for rate recovery.

c. The Commission Should Reject Avista's Two Adjustments to Test Period Rate Base, and Should Reject Most of Its Proposed 2008 and 2009 Pro Forma Capital Additions.

52 Avista proposes two adjustments to the test period rate base. First, the Company abandons the average-of-monthly-averages method used by the Commission to measure rate base, proposing instead to adjust rate base to the end of the test period. Second, the Company moves the end of test year plant in service to a pro forma amount as of December 31, 2008, three months after the end of the test period. The Commission should reject these adjustments. Only in rare, exceptional cases, has the Commission allowed the end-of-period approach, in periods of high inflation or rapid infrastructure growth. Even then, the Commission has required matching of revenues and costs to the proposed period end, which

[57] Tr. 630-631 (DeFelice).

Avista has not done. Finally, the Commission has never approved an end-of-period test year that concludes three months after the actual test-year results.[58]

53 Avista also proposes to include numerous capital projects that were put into service, or are merely projected to be put into service, well beyond the end of the test year—from October 1, 2008, to as late as December 31, 2009. With the limited exceptions previously noted by Mr. Kermode, the Commission should reject these pro forma additions, because they are either not known or measurable, or they do not include all offsetting factors (including benefits or cost savings), or both.

54 Staff conducted significant discovery following Avista's filing of this general rate case in January 2009, including a review of the Company's many capital projects. However, Staff completed its audit of capital projects on June 30, 2009. Only projects completed by this date, and subject to audit, are thus known and measurable. Yet Avista proposes, on rebuttal, to include a litany of projects that extend all the way to December 31, 2009. The difference between these two dates is critical. As Mr. Kermode pointed out at the hearing, the Company's inclusion of capital projects not put in service until the latter half of 2009 requires the use of "budgeted amounts," "projected amounts," and, in essence, a Company "wish list," as the basis of its proposed pro forma adjustments.[59] This turns historical test-year basis ratemaking on its head. The budgeted dollar amounts in question are not contractually obligated amounts, and, not surprisingly, they have changed since the Company filed its original testimony—as indicated by Mr. Storro's rebuttal testimony—[60]

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[58] Kermode, Exh. DPK-1T at 31-32.
[59] Tr. 746 (Kermode).
[60] Mr. Storro confirms in his rebuttal testimony that the "planned expenditures" for these 2009 projects, as originally set forth in Mr. DeFelice's direct testimony, have since increased by more than $700,000, demonstrating that these costs are not known and measurable, but are subject to continual change. Storro, Exh. RLS-7T, at 3.

and they may change yet again between now and the time that rates are in effect. They simply are not known and measurable amounts.

55 Even as to capital projects put into service prior to June 30, 2009, the Company fails to show that it has included all offsetting factors. On rebuttal, Avista makes a belated attempt to do so, but once again, it presents nothing more than predictions, projections, and best guesses. The Commission is being asked to rely on Avista's assurance that it has been "liberal in our estimates of the benefits" of all of these projects as a basis for saddling ratepayers with millions of dollars post-test year capital expenditures.

56 Mr. DeFelice, Mr. Howell, and Ms. Cummins all put forth projected "efficiency factors" that they contend reflect the benefits or cost savings associated with each of Avista's capital projects. No work papers support these factors; rather, they are just the Company's prediction of how much savings will be realized by the capital investment. Moreover, the Company uses these efficiency factors by simply reducing rate base by some estimated percentage (0%, 5%, 10%, 20%, or whatever number the Company believes is proper),[61] rather than directly reflecting the actual reductions in expenses or costs that will occur. The witnesses all seek to reassure us by concluding:

> In order to be conservative (err on the side of over-stating benefits), in the development of the alternate rate base approach, the Company analyzed each capital project listed above and employed its best judgment to identify any possible increase in revenues and/or reductions in expenses associated with the capital projects. The Company was liberal in our estimates of the benefits and erred on the side of overstating the benefits in response to Staff's concerns.[62]

This simply is not how ratemaking is done in Washington. The Company has not met its burden of demonstrating that its proposed capital expenditures properly incorporate all

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[61] *See* DeFelice, Exh. DBD 4T at 17-18; Howell, Exh. DRH-1T at 5, 7; Cummins, Exh. HLC-1T at 4-6. Tr. 631-632 (DeFelice).

[62] DeFelice, Exh. DBD-4T at 18. Mr. Howell and Ms. Cummins conclude their rebuttal testimony with virtually identical language. Howell, Exh. DRH-1T at 7. Cummins, Exh. HLC-1T at 6.

offsetting factors. To merely provide projections and self-described "liberal" estimates of "possible increases in revenues/and or reductions in expenses" does not meet the requirements of WAC 480-07-510 (3)(e)(iii) that all such offsets be actually known and measurable. Avista's proposed adjustments should, therefore, be rejected.

d. If the Commission allows any pro forma capital additions other than the Noxon 1 and Noxon 3 Upgrades, they should be limited to the 2009 projects set forth by Mr. Kermode.

57 Mr. Kermode has identified a limited number of additional projects that would be eligible for pro forma recovery under a more liberal interpretation of the pro forma principle,[63] including smaller transmission and distribution projects that are required by rule or regulatory requirement, or that are required for system reliability. These projects have either minimal or no offsetting factors, when viewed on an item-by-item basis. Significantly, Mr. Kermode's additional pro formed projects include *only* those in service prior to June 30, 2009, as Staff's audit of completed projects concluded on that date.

58 If Mr. Kermode's selected 2009 capital additions are included for rate recovery in this case, Avista's electric revenue requirement will be increased by $3,782,000.

e. Noxon #1 and Noxon #3 Upgrades.

59 Avista proposes adjustments for Noxon generation, including both the Noxon #1 and Noxon #3 upgrades. Noxon #1 was completed and in service in April 2009. Noxon #3, a similar project, is expected to be completed and in service in April 2010. As Mr. Parvinen notes, the Commission has permitted major resource acquisitions outside of the test year to be included as pro forma adjustments, particularly where the offsetting factors can be

[63] The more liberal reading of WAC 480-07-510 (3)(e)(iii) would allow pro forma recovery for capital projects that are known and measurable where offsetting factors, on an item-by-item basis, can be determined and accounted for. Absent an entire test year's worth of data, however, there may be other offsetting factors (e.g., reductions in expenditures or savings in other parts of the Company's overall budget) that cannot be fully determined at this time.

captured for the benefit of ratepayers.[64] Here, since both of these projects are included within the Aurora dispatch model, the power supply adjustment will capture all material offsetting factors.[65] Thus, Staff does not disagree in principle with including these two acquisitions as pro forma adjustments.[66]

60 However, Staff adjusted Noxon #3 for the fact that it will be used and useful for only nine months of the rate year. The invested cost was weighted so that recovery will be equal to nine months, consistent and matched to the benefits measured in the pro forma power cost adjustment.[67] On rebuttal, the Company contends that Staff should have included 100% of the 2010 cost for rate recovery, since 100% of the additional generation has been factored into Avista's Aurora power supply model. This is simply incorrect. Cost recovery and cost modeling are two different things. As Mr. Kermode stated:

> [M]y focus is on cost recovery and what should the ratepayer pay. The plant is going to be online for nine months. The ratepayer should only pay for nine months worth of that plant. . . .Because the [Aurora] model itself has it in for a year and that gives me the support to include it in the test year, it doesn't require me to make the ratepayer pay more than they should.[68]

61 Staff's proposed adjustment increases Avista's electric revenue requirement by $2,633,000. This is $1,667,000 greater than the Company's proposed increase of $965,000, due to the addition of Noxon #1 in Staff's PF-8 adjustment.[69]

9. Asset Management

62 The Commission should reject Avista's proposed adjustment for its Asset Management Program because it does not meet the definition of a pro forma adjustment in

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[64] Parvinen, Exh. MPP-1T at 9.
[65] Kermode, Exh. DPK-1T at 39-40.
[66] Staff has included both Noxon #1 and Noxon #3 in Mr. Kermode's PF-8 adjustment, whereas Avista included Noxon #1 in its PF-7 adjustment (which also includes various other unrelated 2009 capital projects) and Noxon #3 in its PF-8 adjustment.
[67] Kermode, Exh. DPK-1T at 40.
[68] Tr. 740 (Kermode). In Staff's revised response to Bench Request 2, Staff also made a correction for data that had been previously transferred incorrectly into the model for revenue requirements. *Id.* (Kermode).
[69] Kermode, Exh. DPK-2 (Summary of Adjustments), revised November 6, 2009.

WAC 480-07-510 (3)(e)(iii). First, the amounts sought to be recovered for asset management are not known and measurable amounts. They are, instead, estimates, projections, or simply management's judgment as to expenses that Avista will incur in the future. When asked whether the Company has any invoices or payments to substantiate the amounts proposed to be included in asset management, Ms. Andrews replied, "Not specific invoices, because these are, you know, this is the level of expense that the Company feels is appropriate for 2010."[70] Put another way, "[T]hese are expected costs that we have included in our budget and other forecasting means of what we expect these costs to be, yes."[71] Yet budgeted costs are not contractually obligated costs, and budgets can and do change. There is simply no assurance that Avista will ultimately spend what it says it plans to spend on asset management in 2010.

63 Second, the Company has failed to quantify all of the offsetting benefits that will accrue from its asset management. Mr. Kinney states the program is intended to "maximize system reliability and value for our customers,"[72] but he includes no offsetting amounts for increased revenue or decreases in costs. On rebuttal, Mr. Kinney opines that the programs "will produce savings for our customers over the long term, however, the majority of the savings will be observed in future years."[73] Then, again based solely on the Company's "forecasts" and "projections" of future spending and savings, he contends that there will be almost no net overall change in O&M expenditures in 2010 compared with the test year.[74] Mr. Kinney acknowledges that a "mature" asset management program may provide additional offsetting factors, but he says these are difficult to quantify, and further opines

[70] Tr. 533-534 (Andrews).
[71] *Id.* at 534 (Andrews).
[72] Kinney, Exh. SJK 1T at 19.
[73] Kinney, Exh. SJK-4T at 14.
[74] *Id.* at 15.

that "[t]he Company believes that any additional revenue received through reduced outages will not be significant and therefore won't offset the increased maintenance costs associated with failed equipment based on current and forecasted expenditures."[75]

64 These vague statements of belief and conjecture are not enough to meet the rigorous standards of WAC 480-07-510 (3)(e)(iii). Avista has failed to meet its burden of proving that the costs it wishes to impose on ratepayers are known and measurable with no offsetting factors. The Commission should therefore reject Avista's proposed asset management program adjustment, which reduces its electric revenue requirement by $3,028,000, and reduces its natural gas revenue requirement by $92,000.[76]

10. Information Services

65 The Commission should reject Avista's proposed adjustment for its Information Service expenses. These costs do not meet the definition of a pro forma adjustment in WAC 480-07-510 (3)(e)(iii), because they are not known and measurable amounts.
Mr. Kopcznski's testimony, consistent with other Avista witnesses, confuses budgeted amounts with known and measurable amounts. He states, "The expenditures that the Company has pro formed in this case include the administrative and general (A&G) expenses associated with incremental *known and measurable changes* for labor and non-labor informational services costs *planned* for 2010 above the test period[.]"[77] As Mr. Kermode correctly points out, "'Planned costs' as used by Mr. Kopczynski in his testimony are simply budgeted costs and not known and measurable[.]"[78]

66 Mr. Kensok's rebuttal testimony is no more helpful. He states that "the costs requested in this case are associated with existing technology and labor that are already

[75] *Id.* at 16.
[76] Kermode, Exh. DPK-2 (Summary of Adjustments), revised November 6, 2009.
[77] Kopczynski, Exh. DFK-1T, at 7 (Emphasis added).
[78] Kermode, Exh. DPK-1T at 43.

employed, and therefore are known and measurable."[79] But the mere fact that a budgeted cost is associated with existing technology does *not* make that budgeted cost known and measurable. It is still merely a planned, unobligated, and currently budgeted expense for 2010. The Company may, in fact, change its planned expenditures before they occur (as it has revised its estimates of certain other costs during this case).

67 Otherwise Mr. Kensok's rebuttal testimony is simply a listing of projects, with a projected cost and a description of the projects, that falls far short of providing support for the level of pro forma costs the company proposes its rate payers should carry.[80] The Company belatedly includes "offsets" of 20%, for two of the projects--and then only after Staff highlighted the fact that the Company had included no offsetting benefits of any kind in its direct testimony. But even these seemingly arbitrary "offset" amounts are not, ironically, known and measurable themselves.[81]

68 The Commission should, therefore, reject Avista's proposed Information Services adjustment, which reduces its electric revenue requirement by $1,114,000, and reduces its natural gas requirement by $288,000.

11. Pension Assets and Employee Benefits

69 Avista requests approval to establish a regulatory asset for the carrying costs of the cumulative difference between payments and authorized pension cost.[82] Staff opposes this request. In his testimony, Mr. Kermode explains that Staff's opposition is based primarily on the fact that allowing a carrying charge on the difference would actually allow two

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[79] Kensock, Exh. JMK-1T, at 3 (Emphasis in original).
[80] Mr. Kopczynski's direct testimony contained only one question, and fourteen lines of testimony with no supporting detail, to support the Company's original $1.8 million adjustment, even though the underlying costs reflected 16 different categories of costs. Kopczynski, DFK-1T at 7-8; Kermode, DPK-1T at 43.
[81] Mr. Kensock says, regarding the 20% reduction for the New Mobile Dispatch Application, "These savings would not be reflected in the test year, and although difficult to quantify at this time, to be conservative (overstate, if anything, the offsets) the Company has included a reduction of 20% of the total cost in its revised adjustment[.]" Kensock, Exh. JMK 1T, at 6.
[82] Thies, Exh. MTT-1T at 37.

returns on the same investment, one on the fund itself and a second on the Company's proposed carrying charge.[83] Furthermore, the Company has wide discretion on the amounts that are contributed to the pension fund. This wide discretion, coupled with the requested proposed accounting that would allow the creation of a regulatory asset, creates an economic incentive for excess contributions above those that would normally be contributed by the company.[84] The Company did not rebut Staff's testimony on these two points. Staff, therefore, recommends that the Commission oppose the Company's request.

12. The Commission Should Address Avista's Energy Recovery Mechanism (ERM) Separately From The Revenue Requirement Determined In This Case.

70 At the time of its original filing, Avista stated that it was seeking a 16.0 percent increase in electric rates. However, Avista also proposed that the Commission reduce its Energy Recovery Mechanism (ERM) surcharge from 7.4 percent to zero, concurrently with the rates approved in this filing, regardless of the deferred ERM balance. As a practical matter, Avista did this so that it could present this case as one in which the "bill impact on customers" would be an increase of only 8.6 percent. Any remaining ERM balance would be carried over and recovered in a future period.[85]

71 Staff opposes Avista's recommendation to cosmetically dress up its requested rate increase in this docket as anything less than it actually is. The ERM balance is simply not at issue here. The original ERM surcharge was put in place to recover extraordinary costs associated with the power crisis of 2000-2001, and was designed to stay in place until the balance reached zero. The Company estimates that it will reach zero in January 2010. The end of the suspension period in this case is December 23, 2009. Therefore, Staff believes

[83] Kermode, Exh. DPK-1T at 47.
[84] Kermode, Exh. DPK-1T at 47-48.
[85] Morris, Exh. SLM-1T at 3; Norwood, Exh. KON-1T at 30.

that customers should see that surcharge be reduced to zero on its own merits, rather than be artificially used to offset a large general rate increase. Customers should see these as two distinct events. Staff also does not believe that customers will be troubled by seeing two rate adjustments, when one of these is an end to the ERM surcharge that has been in place since October 2001.[86]

72 Avista's revised recommendation presented by Mr. Norwood on rebuttal, to reduce the ERM surcharge so that it is recovered over a 12-month period,[87] should also be rejected. There is simply no reason to inject the ERM surcharge, or recovery of the deferred ERM balance, into this general rate case. The 12 month amortization goes against the mechanism itself, which states that the surcharge stays in place until the balance goes to zero, and then the surcharge stays at zero until such time as the balance reaches 10% of general revenues.[88]

B. LANCASTER CONTRACTS

73 Staff reviewed the Lancaster Contracts at length, and determined that it would not contest the inclusion of these contracts in Avista's revenue requirement in this case. As stated by Mr. Buckley at the hearing, Staff viewed Lancaster as a reasonable acquisition of a long-term resource at a favorable price, and one that would benefit ratepayers in Washington for years to come.[89]

74 The key issue for Staff was that Lancaster should be viewed as a long-term acquisition. Mr. Storro's testimony indicates that the Power Purchase Agreement for Lancaster will be available to the Company from January 1, 2010 to October 31, 2026. Staff

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[86] Parvinen, Exh. MPP-1T at 14-15.
[87] Norwood, Exh. KON 1T at 30-31.
[88] *WUTC v Avista Corporation*, Docket UE-011595, Fifth Supplemental Order, Settlement Stipulation at 7-8, ¶ II.4.f. (June 18, 2002).
[89] Staff did not prefile testimony on the Lancaster Contracts issue. Staff determined not that it would not challenge inclusion of these contracts in revenue requirement, and therefore would not oppose the Company on this issue. In retrospect, Staff recognizes that prefiled testimony would have, nevertheless, been of assistance to the Commission.

compared this low-cost resource to others that were available in the market and felt that qualitatively, this was a sound transaction.[90] Staff analyzed the Lancaster transaction in light of other recent similar acquisitions before the Commission, (such as Coyote Springs 2, Goldendale, and Frederickson) and found that it compared favorably. This was a resource with a favorable rate, located very well for purposes of generation.[91] Mr. Kalich's rebuttal testimony confirms that Lancaster's costs are reasonable when compared to the alternatives available, at $550/kW versus an average of $865/kW.[92]

75 Staff is aware that Public Counsel has focused particularly on the year 2010, and the fact that if this one year is singled out, the transaction might be viewed much more negatively, because in that year alone, the transaction might be deemed a "money loser".[93] However, as Mr. Buckley emphasized, there is no certainty that this resource would be available starting in 2011. Avista Corporation, the parent corporation, has a duty to both its ratepayers and its shareholders, and there is no guarantee that it would hold off on perhaps dealing with another utility to save this for Avista Utilities in 2011.[94] For this reason, Staff also does not believe that the presence or absence of a contract between Avista Utilities and Avista Turbine is determinative.

76 Staff also disagreed with Public Counsel's contention that the Lancaster Contracts are prohibited by a prior Commission Order and settlement stipulation in Docket UE-011595.[95] That stipulation stated that Avista agreed not to enter into "commodity transactions" with Avista Energy related to Avista Utilities' electric operations until the

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[90] Tr. 945-946 (Buckley).
[91] Tr. 950-952 (Buckley).
[92] Kalich, CGK-4T at 5-6.
[93] Tr. 959-960 (Buckley).
[94] Tr. 960, 962-963 (Buckley).
[95] *WUTC v. Avista Corporation,* Docket UE-011595, Fifth Supplemental Order, Settlement Stipulation at 7, ¶ II.4.e. (June 18, 2002).

energy cost deferral balance carries a net credit. In Staff's view, this provision was meant to address concerns over hourly, secondary market purchases. Staff does not believe that an acquisition of the full operating rights of a large power plant is a "commodity transaction," within the intent of that provision.[96]

77 Finally, Staff agrees that the acquisition should meet the standard associated with affiliated transactions, that being the lower of cost or market.[97] Mr. Kalich's testimony confirms that the Lancaster Contracts meet this standard.[98]

78 In summary, Staff thoroughly reviewed the Lancaster Contracts.[99] As a result of that review, Staff determined that it would not contest inclusion of those contracts in the Company's revenue requirement.

C. STAFF RECOMMENDS THAT THE COMMISSION DISCONTINUE AVISTA'S PILOT DECOUPLING MECHANISM IN 2011, DECREASE THE SCHEDULE 101 USAGE CHARGE, AND GRADUALLY INCREASE THE BASIC CHARGE IN 2010 AND 2011.

1. Background

79 On February 1, 2007, the Commission entered its Final Order Approving Decoupling Pilot Program[100] which allowed Avista Corporation (Avista) to implement a mechanism to decouple its rates for conducting business operations, in part, from its rates for commodity sales. Mr. Hirschkorn's testimony[101] provides a complete description of the mechanism.[102] On March 31, 2009, Avista filed an evaluation of the decoupling mechanism. On May 1, 2009, Avista filed a request to extend the decoupling mechanism until the Commission

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[96] Tr. 941-944 (Buckley).
[97] Tr. 945 (Buckley).
[98] Kalich, Exh. 4T at 4-8.
[99] Tr. 1054-1056 (Buckley).
[100] *WUTC v. Avista Utilities,* Docket UG-060518, Order 04, ¶¶ 1-49 (February 1, 2007).
[101] *WUTC v. Avista Utilities,* Docket UG-060518, Petition, Motion, Direct Testimony and Exhibits on behalf of Avista Corporation from Kelly Norwood, RE: Order Continuing a Natural Gas Decoupling Mechanism with Associated Accounting Entries, Hirschkorn Exhibit No. ___ (BJH-1T), Pages 13-19 (May 1, 2009).
[102] Hirschkorn, Exh. BJK-1aT, at 13-19. (May 1, 2009).

completed its consideration of whether it should be implemented permanently.[103] On May 15, 2009, the Commission consolidated the decoupling docket with the Company's general rate case.[104] Later, on June 30, 2009, [105] the Commission granted a temporary extension of the decoupling mechanism.[106] The question now is whether the decoupling mechanism should be made permanent.

2. For Several Reasons, Staff Recommends that Avista's Pilot Decoupling Mechanism Should Be Discontinued.

a. Decoupling is intended to encourage the Company to increase its investment in conservation. However, Avista has not shown that the pilot mechanism furthered this important goal. Moreover, decoupling has generated recovery for Avista far in excess of lost margin resulting from Company-sponsored DSM.

80 Decoupling is intended to encourage the Company to increase its investment in conservation.[107] Whether Avista's pilot program has, in fact, done so is a key question which the consultant, Titus, should have directly addressed in its lengthy report on decoupling, but did not. In order to determine whether conservation increased as a result of implementing decoupling, the consultant should have discussed the potential advantages and disadvantages of the program, including risk factors and any changes in risk to the customer or the Company, as well as whether price signals were appropriate under the mechanism, and whether there was any evidence of changes in customer behavior due to the mechanism.

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[103] *WUTC v. Avista Utilities,* Docket UG-060518, Petition, Motion, Direct Testimony and Exhibits on behalf of Avista Corporation from Kelly Norwood, RE: Order Continuing a Natural Gas Decoupling Mechanism with Associated Accounting Entries (May 1, 2009).
[104] *WUTC v. Avista Utilities,* Dockets UE-090134, UG-090135, and UG-060518, Order 06, ¶¶ 1-18 (May 15, 2009).
[105] *WUTC v. Avista Utilities,* Dockets UE-090134, UG-090135, and UG-060518, Order 07, ¶¶ 1-36 (June 30, 2009).
[106] *See* Reynolds, Exh. DJR-1T at 3-4.
[107] *WUTC v. Avista Utilities,* Docket UG-060518, Order 04, ¶¶ 21); Reynolds, Exh. DJR-1T at 4:19.

As Staff strongly urged during the preparation of the consultant's Final Report, the Commission would have benefited from a more thorough analysis by the consultant.[108]

81 Avista had a fairly well-developed conservation program even before decoupling was put into place. Both conservation program and therm savings increased during the term of the decoupling mechanism. However, during the last four years, therm savings have fluctuated wildly, decreasing almost as much as they have increased.[109]

82 An accurate measurement of Avista's Demand Side Management (DSM) therm savings is important to determining whether decoupling should be continued. However, the claims and estimated amounts of these savings varies considerably. The Titus report shows therm savings increasing from 1,060,467 therms in 2006 to 1,752,330 therms in 2008.[110] However, the Triple E Report indicates that Avista's therm savings were 1,888,061.[111] These de-rated savings are calculated differently, but the different numbers still illustrate how much uncertainty there is about Avista's savings claims. The amount continues to remain in dispute. In Docket UG-091399 (the decoupling surcharge filing for the final reporting period of Avista's decoupling pilot), the Company just recently filed a letter with the Commission in which it reduced its claimed amount of 2008 DSM savings from 1,821,298 therms (as shown in the Company's original filing) to 1,568,856 therms.[112] Mr. Norwood acknowledged that Staff and Public Counsel believe the actual level of savings was, in fact, lower, and stated that the Company did not agree with their conclusions. At the very least, however, the amount of 2008 DSM therm savings is highly

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[108] Reynolds, Exh. DJR-1T at 7.
[109] *Id.* at 8.
[110] *See* Hirschkorn Exh. BJH-2a at 3, Table 2.
[111] Second revised Exh. BJH-2a on behalf of Avista Corp. from Kelly Norwood (scanned & posted-disk), filed September 29, 2009, UE-09134 Exhibits 7-8.pdf, Page E-185, Table 6G, Total Therms Line.
[112] *See* October 22, 2009, Letter from Kelly O. Norwood to David Danner, entitled "Docket No. UG-091399-Revised Filing, Avista's Proposed Natural Gas Decoupling Rate Adjustment."

disputed, and all parties now acknowledge that this amount is now much less than Avista originally claimed, by all calculations.

83 Moreover, Avista's decoupling mechanism generates recovery far out of proportion to the lost margin caused by Company-sponsored DSM programs. Mr. Hirschkorn confirmed, in fact, that during 2007 and 2008, the first-year lost margin resulting from DSM-measured savings for residential (Schedule 101) customers was only 16 percent of the deferrals recorded under the decoupling mechanism.[113] Over the first two years of the program, the Company deferred $1,611,837, while it lost $253,000 of margin due to Company-sponsored DSM. Even if one incorporates multi-year losses, the Company still deferred $1,057,107, or four times the impact of its DSM program. Unfortunately, the Titus evaluation report did not attempt to measure how much of the margin may have been associated with market transformation, or with information programs sponsored by the Company. The evaluation report did not try to determine the causes of non-Company sponsored conservation.[114]

84 The bottom line is, that while decoupling has generated significant revenue recovery for Avista, the Company has not shown that decoupling has encouraged it to increase its investment in conservation.

b. Residential customers already contribute a higher proportion of revenue than other users of natural gas, and decoupling increases this inequity even more.

85 As Ms. Reynolds points out, Avista's residential customers already contribute a higher proportion of revenue than other users of natural gas. According to Mr. Hirschkorn's calculations, the present rate of return for Schedule 101 (residential customers) is 6.98 percent, while it is 6.93 percent for Schedule 111 (large general service customers) and 6.48

[113] Hirschkorn, Exh. BJH-1T at 11.
[114] Reynolds, Exh. DJR-1T at 19.

percent for Schedule 121 (extra large general service customers). If the revenue received from the decoupling mechanism were included in the Company's calculations, the return would be even higher. This is illustrative of a class inequity that is exacerbated by the decoupling mechanism.[115]

c. The new customer adjustment allows Avista to defer too much revenue.

86 Staff disagrees with inclusion of a new customer adjustment in Avista's decoupling mechanism. The point of decoupling is to stabilize revenues for the Company. Historical growth in electric revenue has been driven by increases in both use per customer and customer numbers. However, natural gas has been experiencing a decline in use per customer for at least ten years. The mechanism's current design incorrectly assumes that the Company's costs per customer have no incremental component. For example, the Company does not have to buy new equipment every time it adds a new customer to the system. The new customer adjustment fails to take into account these economies of scale.

87 However, the new customer adjustment is currently so large that removing it changes the deferral from $674,000 collected from customers to $203,000 refunded to customers. Staff believes that an alternative rate design—rather than retaining decoupling without the new customer adjustment—would better serve the policy goal of stabilizing Avista's revenue.[116]

d. Avista did not demonstrate that its decoupling mechanism sends the right price signals to customers.

88 Proponents of decoupling suggest that maintaining higher usage charges are a stronger incentive for customers to conserve energy, even though that same situation has the opposite effect on the Company's incentive to invest in conservation measures. To

[115] *Id.* at 20.
[116] *Id.* at 21-22.

determine whether this is true, Avista should have engaged in a thorough analysis of the price signals that decoupling sends to customers, compared to other pricing mechanisms. As Ms. Reynolds stated, a review of price signals should consider low, high, and average use customer experience under the current tariff, and consider what happens to typical customer bills under multiple conservation scenarios. It should also compare price signals under other rate designs. However, the Company did not engage in this analysis. Instead, the evaluation report provides only low, high, and average use customer bill impacts under the current decoupling mechanism.[117]

89 And, as Ms. Reynolds noted, it is simply unclear to what extent the decoupling mechanism, which changes the average customer's bill by less than one percent,[118] actually affected customers' implementation of conservation measures. Other factors such as programmatic DSM programs, education, and social norms may in fact be more responsible for behavioral change in favor of conservation. Furthermore, Ms. Reynolds demonstrated that price signals to customers under either a straight-fixed variable rate design, or Staff's proposed rate design (raising the basic charge to $10.00) are the same as under decoupling, for the average individual customer. First, the three different rate designs all reward the average use customer when the customer conserves natural gas. Second, the bill impact on an average use customer is almost exactly the same under either Staff's worst case decoupling analysis (i.e., a company-wide 10% reduction in energy use) or the straight fixed-variable rate design. This means that if Avista's investment in conservation becomes truly successful, the customer will experience the same bill impacts under either rate

[117] *Id.* at 11-12.
[118] Hirschkorn, Exh. BJH-2a at 4.

design.[119] These nearly identical price signals undercut the contention that maintaining decoupling is necessary to encourage conservation.

e. Decoupling creates a large administrative burden for the Commission, Staff, and the Company that could be avoided by implementing Staff's recommended alternative rate design.

90 Finally, Avista's decoupling mechanism creates a large administrative burden for the Commission. Seven reports, totaling over 300 pages, must be reviewed to analyze the mechanism. This does not include the 900 pages of exhibits included with the Evaluation Report.[120] The complexity of all the audits, adjustments, and analyses required under Avista's decoupling mechanism was made clear during cross-examination of Mr. Hirschkorn about all of these items at the hearing.[121] The Company spent considerable time on decoupling, involving three of its staff from the rate area.[122] In addition, Avista DSM staff spent about half an FTE over the course of the entire development of the evaluation plan, the evaluation report, and the data responses.[123] Yet, the benefits derived from decoupling have not been shown to justify this burden. As set forth below, Staff's alternative proposed rate design would send the right price signals to customers, would not discourage conservation by the Company or customers, and would do so with far less administrative burden.

3. The Commission Should Approve Staff's Alternative Recommendation to Increase the Customer Basic Charge to $8.00 in 2010, and to $10.00 in 2011, and to Reduce the Usage Charge.

91 Staff recommends that the Commission discontinue Avista's decoupling mechanism at the end of 2010. In its place, Staff recommends increasing the basic charge to $8.00 per

[119] *See id.* at 12-14.
[120] *See id.* at 28-29.
[121] Tr. 1111-1124 (Hirschkorn).
[122] Tr. 1105 (Hirschkorn).
[123] Tr. 1200 (Powell).

month on January 1, 2010, and then to $10.00 per month on January 1, 2011. Staff also recommends decreasing the usage charge as shown in Ms. Huang's Exhibit JH-3. These changes would increase the amount of fixed revenue that Avista can collect through the basic charge, without increasing its Schedule 101 (residential) revenue requirement. This stabilizes the revenues that the Company can expect to receive, without the complex accounting requirements associated with the present decoupling mechanism.[124]

92 The Commission has expressly stated its interest in promoting rate stability:

> As a general proposition, there are sound reasons supporting recovery of a greater proportion of a utility's fixed costs in basic or demand charges, rather than in energy or commodity charges. For example, in an environment of increasing costs, a rate design that increases the recovery of fixed costs in fixed charges can promote rate stability while tempering the need for higher returns by reducing the risk the Company faces in terms of overall rate recovery.[125]

93 Staff's proposal to gradually increase the basic charge to $8.00 and then to $10.00 is also consistent with the costs incurred in serving customers. Mr. Hirschkorn stated at the hearing that the average embedded cost for meter service, meter reading, and billing for all existing customers is $8.07.[126] The Company's cost of service study presents a natural gas customer cost, per customer, per month for Schedule 101 of $13.40.[127] Staff's proposal places the basic charge well within this range.

94 Moreover, Staff's proposal is unlikely to have an impact on customers' incentive to conserve, since only 14 percent of the annual bill will be in the basic charge. This is because natural gas costs are far and away the biggest part of the customer's bill.[128] It also

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[124] Reynolds, Exh. DJR-1T at 26.
[125] Dockets UE-070804, *WUTC v. Avista Corporation,* Order 05, Final Order Rejecting Tariff Sheets; Approving and Adopting Settlement Stipulation; Requiring Compliance Filing, at 9, ¶ 29 (December 19, 2007).
[126] Tr. 1126 (Hirshckorn).
[127] *See* Knox, Exh. TLK-7, at 3, line 22, column (g).
[128] *See* Reynolds, Exh. DJR-2; Tr. 1266 (Reynolds). The Commission has suggested that the right balance point for recovery of fixed costs via the customer basic charge is about one-fourth of the fixed costs allocated to residential customers, or about eight to ten percent of a customer's average annual bill. *WUTC v. Puget*

is theoretically sound. Ideally, from a Company financial perspective, the fixed costs of providing service would be recovered through a fixed charge each month—since the facilities and support services must be available to serve customers irrespective of how much energy they use.[129] Staff's proposal moves cost recovery closer to this goal, without causing the rate shock that would result if a purely straight-fixed variable rate system were implemented.

95 Staff's proposal to gradually increase the basic charge also addresses the major drawbacks of Avista's current decoupling mechanism, which retains much of the status quo, including the standard two-part tariff employed as the underlying rate design. Year-over-year recovery of fixed costs is directly related to sales of therms, rather than the number of customers connected to the system. Large residential users still contribute more than their share of fixed costs, and small users still contribute less than their share of fixed costs. Small users are overly incented to connect to the system.[130] Staff's proposal will help rectify this problem, so that customers pay their appropriate share of costs.

96 Finally, Staff recognizes that there will always be a probability that significant investment in conservation will reduce company revenues, because a portion of fixed costs are recovered in the usage charge, even under Staff's proposal. However, this would happen over time. Increasing the amount of revenue recovered through the basic charge, as recommended in by Ms. Reynolds, will help to address this problem.

97 Staff, therefore, recommends that the Commission discontinue the Company's decoupling mechanism at the end of 2010, and gradually increase the basic charge to $8.00 on January 1, 2010, and to $10.00 on January 1, 2011.

Sound Energy, Inc., Dockets UE-060266 and UG-060267, Order 08, ¶¶ 139 (January 5, 2007). Staff's proposal sets the basic charge close to this amount.

[129] *See* Hirschkorn, Exh. BJH-1aT at 5.

[130] Reynolds, Exh. DJR-1T at 25-26.

4. Appendix of Decoupling Decisions From Other States

98 Staff has an attached to this brief an Appendix of decoupling decisions from other states.

V. CONCLUSION

99 Staff respectfully requests that the Commission substantially reduce the revenue requirements sought by Avista in this case. Staff recommends revenue requirements of $24.2 million for electric service, and $634,000 for natural gas service. Staff further recommends that the Commission reject Avista's request to address its Energy Recovery Mechanism ("ERM") in this rate case. Finally, Staff recommends that the Commission discontinue Avista's pilot decoupling mechanism at the end of 2010, decrease the Schedule 101 usage charge, and raise the customer basic charge to $8.00 on January 1, 2010, and to $10.00 on January 1, 2011.

DATED this 10th day of November, 2009.

Respectfully submitted,

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