Exhibit No. ___T (JT-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of AVISTA CORPORATION, d/b/a AVISTA UTILITIES, For Continuation of the Company's Energy Recovery Mechanism, with Certain Modifications	DOCKET NO. UE-060181

JOINT DIRECT TESTIMONY OF

KELLY NORWOOD (AVISTA)
ALAN BUCKLEY (STAFF)
STEVEN JOHNSON (PUBLIC COUNSEL)

IN SUPPORT OF
THE SETTLEMENT AGREEMENT

June 12, 2006

I. INTRODUCTION

Q. Please state your names, titles, and who you represent in this matter:

A. Our names, titles, and representation are as follows:

- Kelly O. Norwood, Vice-President of State and Federal Regulation, Avista.
- Alan P. Buckley, Senior Policy Strategist, Staff.
- Steven Johnson, Regulatory Analyst, Public Counsel Section, Washington State Attorney General's Office.
- [ICNU will offer support for the Settlement through statements of its counsel.]

Q. Are you sponsoring joint testimony in support of the Settlement Agreement filed with the Commission on June 7, 2006?

A. Yes. This joint testimony recommends approval of the Settlement Agreement by the Commission. The Settlement Agreement represents a compromise among differing points of view. Concessions were made by all Parties to reach a reasonable balancing of interests. As will be explained in the following testimony, the terms of the Settlement Agreement received significant scrutiny and were supported by sound analysis and sufficient evidence. Its approval is in the public interest. The Settlement Agreement has been marked as Exhibit No. ___ (JT-2).

Q. Would you please briefly describe your educational background and professional experience?

A. Kelly Norwood: I am a graduate of Eastern Washington University with a Bachelor of Arts in Business Administration, majoring in Accounting. I joined the Company in June of 1981. Over the past 25 years, I have spent approximately 14 years in the Rates Department with involvement in cost of service, rate design, revenue requirements and other aspects of ratemaking. I spent approximately 11 years in the Energy Resources Department (Power Supply and Natural Gas Supply) in a variety of roles, with involvement in resource planning, system operations, resource analysis, negotiation of power contracts, and risk management. I was appointed Vice-President of State and Federal Regulation in March 2002.

Alan P. Buckley. I received a B.S. degree in Petroleum Engineering with Honors from the University of Texas at Austin in 1981. In 1987, I received a Masters of Business Administration degree in Finance from the University of California at Berkeley. From 1981 through 1986, I was employed by Standard Oil of Ohio (now British Petroleum – America) in San Francisco as a Petroleum Engineer working on Alaskan North Slope exploration drilling and development projects. From 1987 to 1988, I was employed as a Rates Analyst at Pacific Gas & Electric Company in San Francisco. Beginning in late 1988 until late 1992, I was employed by R.W. Beck & Associates, an engineering and consulting firm in Seattle, Washington, conducting cost-of-service and other rate studies, carrying out power supply studies, analyzing mergers, and analyzing rates of the Bonneville Power Administration and the Western Area Power Administration. I came to the WUTC in December 1993, where I have held a number of positions including Utility Analyst, Electric Program Manager, and the position I presently hold. I have been a witness in numerous proceedings before the WUTC. I also have been a witness in proceedings at the Bonneville Power Administration and at the Federal Energy Regulatory Commission.

Steven Johnson. I have a Bachelor of Science Degree in Chemistry from the Evergreen State College and a Master of Public Administration from the Evans School at the University of Washington. I have been employed as a Regulatory Analyst with Public Counsel Section of the Washington State Attorney General's Office for one year. Prior to my employment with Public Counsel, I was employed at Puget Sound Energy as a Transmission Resource Analyst (Merchant Transmission Planning) for approximately 2-1/2 years, including an internship. I have appeared before the Commission for Public Counsel in several Open Meetings and as a witness in a settlement panel for the PacificCorp/MidAmerican merger.

Q. Would you briefly summarize the Settlement Agreement?

A. Yes. The Parties have agreed to a continuation of the ERM mechanism, with certain modifications, for a period of not less than five years. The following are among the agreed-upon revisions to the existing ERM mechanism:

At present, there is a $9 million annual deadband (also known as the "Company Band" in the original ERM Stipulation). Under this existing deadband, the Company would either absorb, or benefit from, the first $9 million of differences between actual and base power supply costs. A 90 percent Customer/10 percent

Company sharing arrangement applies to all differences between actual and base power costs in excess of $9 million under the current mechanism.

Under the Settlement Agreement, the $9 million annual deadband would be reduced to $4 million and a 50 percent/50 percent sharing between the Company and its customers would apply to any differences between actual and base power supply costs between $4 million and $10 million. Thereafter, a 90 percent /10 percent sharing would apply to all differences between actual and base power costs in excess of $10 million. (See Section 6(A)).

Currently, the ERM tracks variation in net power supply expense, including purchased power and fuel expense, less wholesale sales revenue. The Parties have agreed to revise the ERM to include transmission revenues (FERC Account 456.100) and expenses (FERC Account 565) in net power costs and expenses under the ERM. In this manner, monthly variations in transmission revenues and expenses will be included in the monthly ERM calculations. (Section 6(B)).

Moreover, the ERM's retail revenue credit will include the fixed-cost component of transmission approved for inclusion in rates in the then most recent rate case. The current retail revenue credit, which reflects the average cost of production (power supply) embedded in retail rates, is $32.89/MWh. Until changed, the addition of the transmission cost component of $6.14/MWh results in a new retail revenue credit of $39.03/MWh (Section 6(C)).

Under the Settlement Agreement, there are agreed-upon limitations on the extent to which costs associated with long-term power supply contracts can be recovered through the ERM. For any new power contract (or renewal or extension of an existing contract) with a term longer than two years and of more than 50 megawatts (MW), costs in excess of the lower of the average embedded cost of power supply or the average market rate during the contract, shall be excluded from the actual power supply costs until such time as the contract is incorporated in base rates in a general rate proceeding. Any contracts of up to 50 average megawatts (aMW) under Avista's current renewable energy RFP are exempt from this limitation, however. The use of a 50 average megawatt ceiling for recovery of renewable energy contracts, entered into under Avista's current RFP, through the ERM reflects the much lower capacity factors generally associated with renewable energy resources (e.g. wind). While costs associated with certain power supply contracts still remain eligible for recovery through the ERM, limitations apply to long-term power supply contracts, as discussed above. (Section 6(D)).

In the event of a <u>major plant outage</u> affecting Kettle Falls, Colstrip 3 and 4, and the Coyote Springs 2 generating plants, that causes the plants to fail to meet a 70-percent availability factor, the Company must demonstrate that 1) the fixed costs set in rates were in fact incurred for the time the plants had an outage that reduced the availability factor below 70 percent, and that 2) the outage was not the result of imprudent actions on the part of the Company. (Section 6(E)).

<u>Brokerage fees</u> consist of fees paid to third-party brokers who facilitate electricity and natural gas turbine fuel purchases and sales, and are a component of the Company's power supply expenses. The parties have agreed that monthly variations in broker fees from the amount otherwise embedded in rates, will be included in the monthly ERM calculations (Section 6(F)).

Q. What is the effective date of the revisions to the ERM?

A. The above-referenced revisions to the ERM resulting from the Settlement would be effective beginning January 1, 2006, and except for certain issues described below that have been deferred to the Company's next general rate case filing (GRC), would remain in effect until the ERM is next reviewed, in a filing to be made by the Company, not sooner than five years from the date this Settlement Agreement is approved. Accordingly, Avista would make a filing not sooner than five years from the approval date of the Settlement, in order to allow interested parties the opportunity to review the ERM, and make recommendations to the Commission relating to the continuation, modification or elimination of the mechanism.

Q. Are there certain other matters deferred to Avista's next general rate case?

A. Yes. The parties have agreed (see Section 7) to defer the following matters to the Company's next GRC:

1. The Company must file testimony in its next GRC on the cost of capital impact of the ERM;

2. The Company must also file testimony demonstrating the prudence of its hedging strategy for power purchases and purchases of gas used for power generation, on a prospective basis, in its next GRC;

3. Consideration of the allocation of common costs related to the retail revenue credit would be addressed in the next GRC; and

4. Consideration of a production property adjustment would also be addressed in the next GRC.

Q. Who are the signatories to the Settlement Agreement?

A. The Settlement Agreement, filed June 7, 2006, was signed by Avista, Commission Staff, the Industrial Customers of Northwest Utilities (ICNU), and the Public Counsel Section of the Washington Attorney General's Office. As such, they represent all parties to this proceeding.

II. HISTORY OF FILING

Q. Would you please provide a brief history of the ERM mechanism?

A. Yes. Avista's Energy Cost Recovery Mechanism (ERM) was established pursuant to a Settlement Stipulation between Avista, Staff, Public Counsel, and ICNU, adopted by the Commission on June 18, 2002, in its Fifth Supplemental Order in Docket No. UE-011595. This Settlement Stipulation, by its terms, otherwise required the Company to file for a review of the ERM mechanism prior to the end of 2006. Moreover, in this Commission's more recent Order in Avista's General Rate Proceeding, Docket Nos. UE-050482 and UG-050483, the Commission required Avista to file a Petition on or before January 31, 2006, to initiate further review of the ERM – a condition that would also serve to satisfy Avista's requirement to initiate a review of the ERM prior to the end of 2006. (See Order No. 05, "Approving and Adopting Settlement Agreement With Conditions," entered on December 21, 2005, at Paragraph 177.)

Avista filed its testimony and supporting exhibits on January 31, 2006, recommending continuation of the ERM, but with the elimination of the deadband in its entirety; however, it proposed to retain the 90 percent/10 percent sharing arrangement between the Company and its customers, with respect to differences between actual and base power supply costs. Staff, ICNU, and Public Counsel prefiled their testimony and exhibits on April 21, 2006, suggesting a number of revisions to the ERM, all of which included the retention of a deadband and/or a 50 percent/50 percent sharing arrangement, in various combinations and at various levels. After analysis of these filings, all Parties began settlement discussions in a settlement conference held on April 26, 2006. Thereafter, the procedural schedule was adjusted in order to facilitate additional settlement discussions between the Parties, which resulted in the Settlement Agreement that is before the Commission at present.

Q. Will the process change with respect to the annual ERM filings and the opportunity for review and audit?

A. No. Under the ERM, Avista would continue to make an annual filing to provide the opportunity for the WUTC and other interested parties to review the prudence of and audit the ERM deferred power cost transactions for the prior calendar year. Avista made its annual filing with WUTC in March 2006. The settlement provides that provisions of the original ERM stipulation not modified by this agreement remain in effect.

III. <u>PURPOSE OF THE ERM</u>

Q. What is the ERM mechanism designed to accomplish?

A. The ERM is focused on tracking variability and allowing recovery in the mechanism of certain costs beyond the Company's control caused by variations in weather conditions, as well as prices for fuel and purchased power. In doing this the ERM must also balance the interests of the Company and its customers. The Company has argued that the stability of cash flow and earnings is very important to equity investors and lenders. Avista's heavy reliance on hydroelectric generation, as well as its ownership of gas-fired generation, can result in a significant amount of variability in its power supply operating costs. The ERM provides a measure of stability in earnings and cash flows related to these cost drivers.

Q. Did the Commission, in its recent PacifiCorp Order, provide guidance concerning to the apportionment of risk between ratepayers and shareholders, with respect to power cost recovery mechanisms?

A. Yes, it did. In its PacifiCorp Order, the Commission stated:

> In addition to the principles we have stated previously, we observe that power cost recovery mechanisms should also apportion risk equitably between rate payers and shareholders. In striking that balance, we consider risks already allocated through the normalization process, a utility's financial condition and other circumstances affecting a utility's ability to recover its prudent expenditures. Deadbands and sharing bands are useful mechanisms, not only to allocate risks, but to motivate management to effectively manage or even reduce power costs.
>
> (Order 04, Docket No. UE-050684, at para. 96).

The Settlement Agreement in this proceeding, with the combination of a deadband and a 50 percent/50 percent sharing band (as well as a 90 percent/10 percent sharing band for amounts in excess of $10 million), represents the Parties' efforts to "apportion risks equitably" between ratepayers and shareholders. The Parties attempted to "strike a balance" that considered a number of factors, including

Avista's financial condition and other circumstances affecting the utility's ability to recover its expenditures. Moreover, the Parties to the Settlement have agreed that in its next general rate case, Avista will file testimony on the cost of capital impact of the ERM.

Q. How does the settlement address the Commission's statement in its recent PacifiCorp order, at p. 35, that "ratepayers should receive the benefit of a reduction in cost of capital, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders"?

A. The Settlement provides for a review of the cost of capital impact of the ERM in the next general rate case and requires the Company to file testimony on the effect of the ERM on the cost of capital.

Q. Have the Parties also addressed the issue of whether long-term power supply contracts should be recovered through the ERM?

A. Yes, they have. As previously explained, the Parties agreed that for any new power contract, or any power contract that has been renewed or extended, with a term longer than two years and of more than 50 megawatts (MW), costs in excess of the lower of the average embedded cost of power supply determined in the then most recent rate case or the average market rate during the contract, shall be excluded from actual power supply costs until such time as the contract is incorporated in base rates pursuant to a general rate case.

Q. What is the purpose of the provision dealing with major plant outages? (Section 6(E))?

A. This provision was designed to require the Company to demonstrate, with respect to certain major production plants, in order to gain recovery of costs, that the fixed costs set in rates were in fact incurred during the time the plant had an outage that reduced the availability factor below 70 percent, and that the outage was not the result of imprudent actions on the part of the Company.

Q. Finally, please explain the changes related to transmission revenues and expenses.

A. In its initial filing, Avista had proposed to add transmission revenues and expenses to the ERM, as reflected in the pre-filed testimony of Avista Witness Johnson. (See Settlement Agreement at Section 6(B.)). The fixed-cost component of transmission, however, was at issue in this proceeding, and the Parties agreed that those fixed transmission costs approved for inclusion in rates in the most recent rate case should be included in the retail revenue credit in the ERM. (See Section 6(C)).

IV. CONCLUSION

Q. What is the effect of the Settlement Agreement?

A. The Settlement Agreement represents a negotiated compromise among the Parties. Thus, the Parties have agreed that no particular Party shall be deemed to have approved the facts, principles, methods, or theories employed by any other in arriving at the stipulated provisions, and that terms incorporated should not be viewed as precedent setting in subsequent proceedings except as expressly provided.

In addition, the Parties have the right to withdraw from the Settlement Agreement if the Commission adds any additional material conditions or rejects any material part of the Settlement Agreement.

Q. Why is this Settlement "in the public interest"?

A. The Parties have agreed, given the circumstances of Avista, that it is appropriate to continue with the ERM mechanism, but with certain modifications. Avista's heavy reliance on hydroelectric generation, as well as its ownership of gas-fired generation, can result in a significant amount of variability in its power supply operating costs. It is appropriate to continue for a period of not less than five years a mechanism to address the variability of these costs.

Given adjustments to the deadband and the addition of a 50 percent/50 percent sharing band, together with all other revisions, the Parties believe that this Settlement Agreement strikes a reasonable balance between the interests of the Company and its customers. Moreover, this filing has been subject to extensive scrutiny through the discovery process and all Parties have had an opportunity to develop and articulate their litigation positions in pre-filed testimony. Accordingly, all Parties are conversant with the issues, and have reached a compromise that balances the interests of the Company and its ratepayers.

In the final analysis, any settlement reflects a compromise, in the give-and-take of negotiations; the Commission, however, has before it a Settlement Agreement that is supported by sound analysis and sufficient evidence. Its approval is "in the public interest."

Q. Does that conclude your pre-filed direct testimony?

A. Yes, it does.