BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12_______

DOCKET NO. UG-12_______

DIRECT TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

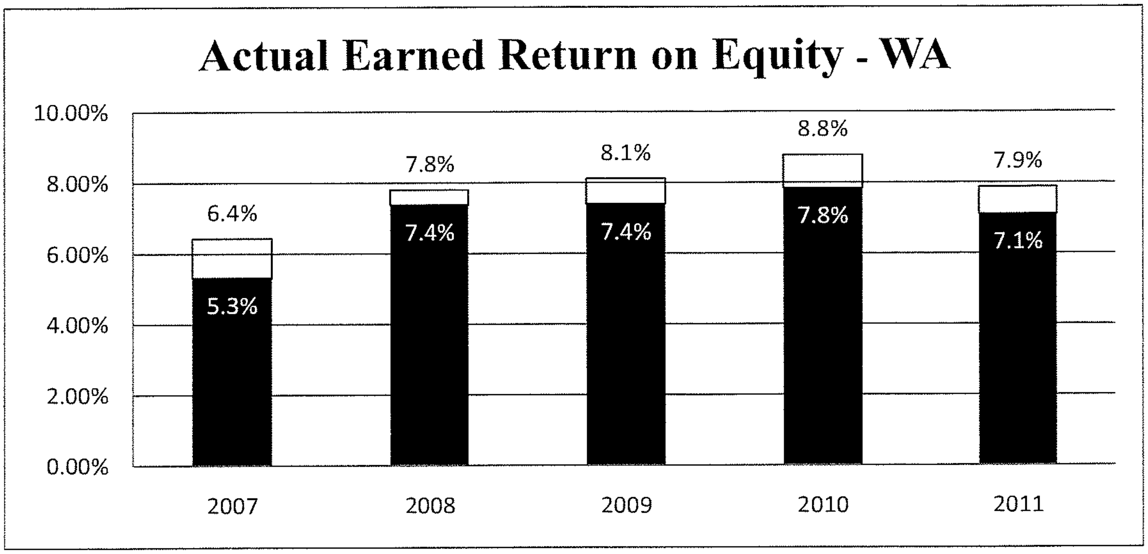
The graph in Illustration No. 2 shows that unless we include adjustments in a general rate case to reflect the actual costs and return associated with serving customers during the period that new retail rates will be in effect (Point B in the graph for the 2012 rate year), Avista will experience a revenue shortfall.

IV. SHORTFALL

Q. How do we know that this shortfall is occurring, and what is the magnitude of the shortfall?

A. The bar chart in Illustration No. 3 below shows Avista's actual earned return on equity (ROE) each year from 2007 to 2011 for our combined electric and natural gas operations in the State of Washington. The ROEs range from 6.4% to 8.8%, and are all well below ROEs approved by the Commission in recent years for utilities in Washington, whether through settlement or litigation. It is worth noting that in 2011, Avista experienced colder than normal weather in its service area, which resulted in higher retail sales, and also experienced above-normal hydroelectric generation for the year; and even under these favorable operating conditions Avista still earned below what would be considered a reasonable ROE. In all of these years, Avista experienced a revenue shortfall, resulting in an earned return well below what the Commission, itself, had determined to be a reasonable return for our shareholders.

Illustration No. 3



Q. What is the difference between the ROEs represented by the black bar each year, and the total ROEs?

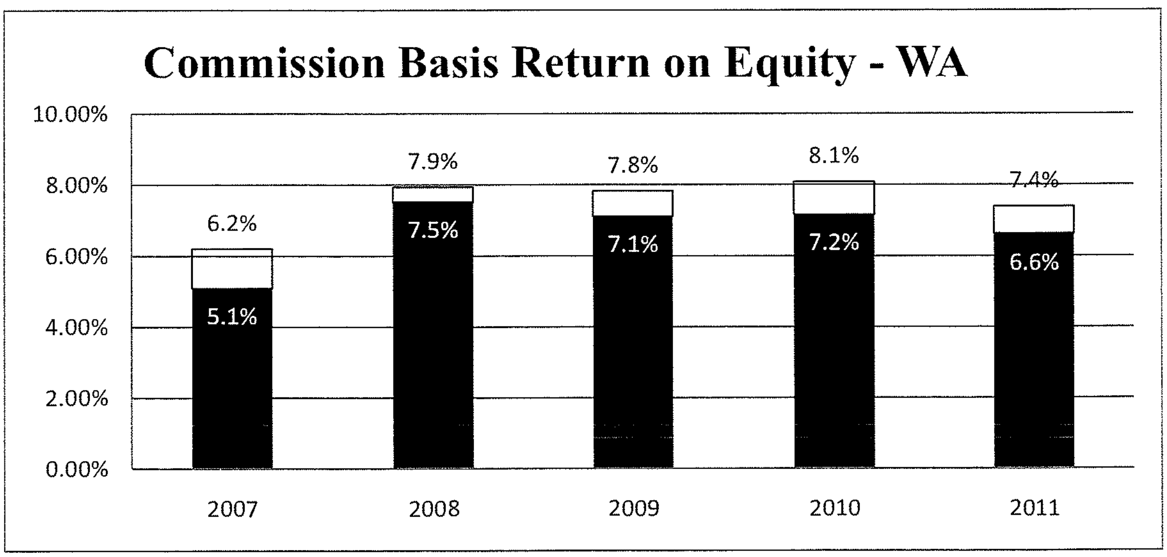
A. The ROEs represented by the black bars each year represent the utility ROEs <u>including</u> the non-utility ("below-the-line") expenses such as lobbying, dues and donations, earnings-based incentive pay, etc. These below-the-line costs are excluded for ratemaking purposes. When these costs are removed, it results in a higher ROE, which is appropriate to compare with the ROE approved by the Commission.

Q. If you were to normalize the operating results for each of these years, how would that change the earned returns?

A. Each year, on or before April 30th, Avista is required to file with the Commission what are referred to as Commission Basis Reports. In developing the reports, Avista normalizes the operating results for the prior calendar year to determine what its rate of return would have been if the Company had experienced normal operating conditions, including, among other things, normal temperatures, normal hydroelectric conditions and wholesale electric prices, removal of prior period adjustments, etc.[2]

The bar chart in Illustration No. 4 below shows Avista's earned return on equity (ROE) each year from 2007 to 2011 for our combined electric and natural gas operations in the State of Washington, under normalized operating conditions. The ROEs range from 6.2% to 8.1%, and, as with the actual ROEs, all are well below ROEs that would be considered reasonable. The black bars, again, represent the utility ROEs <u>including</u> the below-the-line expenses, and the total ROEs represents the ROE excluding these expenses.

<u>Illustration No. 4</u>



The expectation under the regulatory compact[3] is that, over time, there will be a <u>reasonable opportunity</u>, but not a guarantee, to actually earn the return on equity authorized

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[2] In working with Dr. Lowry on the development of the Attrition Study, we discovered some errors in the 2009 and 2010 Commission Basis Reports. We have provided corrected reports to the Commission for these two years through a separate transmittal.

[3] As an investor-owned utility Avista has an obligation to provide service to its customers, and in exchange for that obligation, the Company is entitled to charge fair and reasonable rates. For investor-owned utilities, the

by the Commission. It is understood that, in some years, the return will be below the authorized, and in other years it may be above the authorized. It is not reasonable, however, for the earned return, whether on an actual or normalized basis, to be consistently well below the authorized return every year.

Q. What is the order of magnitude of the chronic revenue shortfall that Avista is experiencing?

A. The Commission Basis (normalized) ROEs from Illustration No. 4 above range from 6.2% to 8.1%. One way to measure the shortfall would be to compare these ROEs to the most recent ROEs authorized by the Commission, which would range from 9.8% to 10.2%. A conservative (minimum) estimate of the shortfall is approximately 200 basis points of ROE. The annual revenue shortfall of 200 basis points of ROE for Avista's Washington utility operations is approximately $21 million.[4]

By comparison, the Attrition Adjustment developed by Dr. Lowry is $20.5 million. Therefore, the attrition adjustment proposed by Avista would appropriately address the revenue shortfall that the Company is experiencing.

Q. Are there specific changes in revenues, expenses or investment that we <u>know</u> are not being reflected in new retail rates established in a general rate case?

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lack of competition is offset with regulation. As Dr. Bill Avera states in his testimony, the U.S. Supreme Court, in the <u>Bluefield</u> and <u>Hope</u> cases, found that a utility's allowed ROE should be sufficient to: 1) fairly compensate the utility's investors, 2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and 3) maintain the utility's financial integrity. Dr. Avera explains in his testimony, "To be fair to investors and to benefit customers, a regulated utility must have an <u>opportunity to actually earn</u> a return that will maintain financial integrity, facilitate capital attraction, and compensate for risk. In other words, it is the end result in the future that determines whether or not the *Hope* and *Bluefield* standards are met.

[4] 2011 restated rate base of $1,327,815,000 x 48.4% equity layer x 2.00% equity return, divided by conversion factor of .620815 = $20.7 million.

A. Yes. Among other cost categories, we know with certainty that our new investment in utility infrastructure each year is greater than our annual depreciation, and we know that very little of this new investment is being included in rate base in general rate cases.

We also know with certainty that we are being successful in assisting our customers to use less energy through our energy efficiency programs. In a general rate case, we begin with historical test period kWh sales, and then erroneously assume that all of those retail sales, and revenues, continue into the future rate year, when we know with certainty that part of that revenue will not occur, because customers have taken steps to use less energy.

Even apart from the impact that energy efficiency has on mitigating load growth, we know with certainty that retail revenue is growing at a much slower pace than operating expenses and net plant investment, as previously shown in Illustration No. 1. Unless the increase in costs, from the historical test year to the rate year, is somehow reflected in retail rates, Avista will not have a reasonable opportunity to earn the authorized return.

V. OTHER INDICATORS

Q. Are there other indicators that Avista is not being afforded a reasonable opportunity to earn a fair return?

A. Yes. Standard and Poor's (S&P) has specifically expressed its view regarding the level of credit support provided by regulation in the State of Washington. In a report issued in March 2010, S&P provided an assessment, or ranking, indicating the level of credit support provided by regulators in each state. Washington was listed under the