

Exhibit No. \_\_\_\_ (DPV-2)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-08\_\_\_\_\_

DOCKET NO. UG-08\_\_\_\_\_

EXHIBIT NO. \_\_\_\_ (DPV-2)

DENNIS P. VERMILLION

REPRESENTING AVISTA CORPORATION

Exhibit No. \_\_\_\_ (DPV-3)

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DENNIS P. VERMILLION

REPRESENTING AVISTA CORPORATION

**BACKGROUND OF SETTLEMENT OF CLAIMS**  
**BETWEEN AVISTA CORPORATION AND**  
**STATE OF MONTANA**  
**(10/31/07)**

1. **Introduction.**

Avista Corporation's federally licensed Clark Fork Project is located on the Clark Fork River, a tributary of the Columbia River. The Clark Fork Project includes the 527 megawatt Noxon Rapids dam and reservoir located in Montana and the 261 megawatt Cabinet Gorge Dam located in Idaho near the Montana-Idaho border. The reservoir for the Cabinet Gorge Dam is located almost entirely in Montana.

In October 2003, Richard Dolan and Denise Haymen, residents of Bozeman, Montana with children in Montana's public school system, filed an action in U.S. District Court in Missoula, Montana against Avista Corporation ("Avista"), PPL Montana, LLC, ("PPL Montana") and PacifiCorp (collectively "Hydroelectric Owners"). Shortly thereafter, Dolan and Haymen were joined by school districts from Great Falls, Montana, which sought to intervene as additional party plaintiffs.<sup>1</sup> Together, the Private Plaintiffs alleged that the State's riverbeds are being utilized by the Hydroelectric Owners, that those riverbeds are "School Trust Lands" under the Montana Constitution, and that compensation is owed by the Hydroelectric Owners to the State on account of their use and occupancy of State lands.

In March 2004, the State of Montana, through the Attorney General, intervened as a party plaintiff in the action. Ultimately, however, the Federal District Court dismissed the lawsuit,

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<sup>1</sup> Dolan, Haymen and the Great Falls School Districts are collectively referred to herein as the "Private Plaintiffs."

concluding that the Private Plaintiffs lacked standing and that the Court did not possess jurisdiction over the matter.

In November 2004, the Hydroelectric Owners filed a declaratory judgment action in Montana District Court in Helena, Montana. In response, the State filed an Answer, Counterclaims and a Motion for Summary Judgment. Because it represented a case of first impression in Montana and the United States, the litigation resulted in briefing and rulings on numerous issues of Constitutional and statutory significance. It further resulted in three major court hearings, consisting of multiple hours of oral arguments before the Montana District Court; extensive discovery, including the exchange of thousands of pages of written documents; and the depositions of 35 party representatives, experts and related witnesses.

In June 2006, PacifiCorp and the State entered into a voluntary settlement, and PacifiCorp was subsequently dismissed from the lawsuit. On October 19, 2007—just three days prior to trial and with the State's damage claim still pending, Avista and the State also entered into a voluntary settlement. Trial of the State's claims against PPL Montana began on October 22, 2007. Those proceedings are ongoing as of this date.

**2. Nature of the Lawsuit.**

The claims of the Private Plaintiffs, subsequently echoed by the Montana Attorney General's pleadings in both federal and state court, are summarized, in pertinent part, as follows:

- a) The beds of navigable waters within Montana's borders became the property of the State under the "Equal Footing" doctrine of the United States Constitution. That doctrine provides that, upon their entry to statehood, the states assumed ownership of the lands beneath navigable waters on an equal footing with the thirteen original states.
- b) Under the Montana Constitution, the lands beneath navigable waters within the State are "School Trust Lands." Under Montana law, the State has a fiduciary obligation to collect full market value for the use of such lands on behalf of the Montana School Trust.

- c) In 1931, Montana enacted the Montana Hydroelectric Resources Act, which requires a license or lease for the occupancy of State-owned lands. Although never before interpreted or applied to the Hydroelectric Owners' facilities in Montana, the Act requires those intending to use state-owned lands to apply for a lease and pay full market rental for such use.
- d) The rental obligations of the Hydroelectric Owners began when they constructed the hydroelectric projects at issue. Therefore, damages owed to the State go back to the original construction of the projects, without regard to any statute of limitations that might otherwise apply.
- e) Avista has wrongfully occupied the Clark Fork River through its operation of the Noxon Rapids Dam and Reservoir, which are wholly located in the State of Montana. Likewise, although the Cabinet Gorge Dam is located in Idaho, most of the Cabinet Gorge Reservoir is located in Montana and, as a consequence, its operation by Avista also results in the wrongful occupation of State-owned lands.<sup>2</sup>
- f) As applied to Avista, the State is entitled to past damages from 1954 to the present, together with future rents at the full market rental value of the land.

3. **Potential Exposure.**

The State of Montana employed Dr. John Duffield, a professor at the University of Montana who is well-known for his expertise in the calculation of natural resource damages, as its expert economist. Dr. Duffield employed a "shared net benefits" methodology to measure the purported damages owed to the State by virtue of the Hydroelectric Owners' occupancy of State-owned lands. Previously, the shared net benefits methodology had been applied only by the Federal Energy Regulatory Commission and federal courts in determining the amount of annual charges to be paid to Indian Tribes under Section 10(e) of the Federal Power Act. Only the State of Maine had applied the methodology in a case not involving tribal lands.

Prior to Dr. Duffield's June 2007 report, the precise magnitude of the State's damage claim was not fully known. In his report, however, Dr. Duffield asserted that, based upon the State's claimed ownership of all lands beneath the navigable waters at issue, Avista owed the

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<sup>2</sup> Although discovery had been conducted regarding the Cabinet Gorge Dam, the facility was not officially incorporated into the case until the State sought to amend its Counterclaim to conform the evidence on the eve of trial.

State in excess of \$542,000,000 for cumulative past rents, and in excess of \$24,000,000 for current 2006 rent, with annual rental payments to continue, as adjusted, for the remaining term of Avista's FERC license (i.e., until 2046).

The initial litigation position of the State concerning damages was revised after the District Court granted Avista and PPL Montana's motion that certain submerged land under the reservoirs was not owned by the State, and that only the original streambeds were at issue. The revised litigation position of the State, as filed with the District Court on October 15, 2007, was that the full market value rental due on Avista's Clark Fork Project was \$200,374,752 for past occupation, together with future rents of \$8,416,510 per year starting in 2006, to be adjusted annually by the Consumer Price Index with a recalculation of the original base amount every 10 years according to the shared net benefits methodology.

As the Counterclaim Defendant, Avista asserted that the State had the burden of proving its ownership of the lands at issue, the precise acreage of those lands, and the proper measure of damages. In addition, Avista was prepared to offer into evidence the testimony of Dr. Thomas Zepp, an economist from Salem, Oregon with extensive knowledge and experience in utility economics and regulation, as well as the shared net benefits methodology. Dr. Zepp was prepared to testify that Dr. Duffield's methodology resulted in a substantial overstatement of potential rents owed by Avista. Additionally, Avista was prepared to introduce testimony from Bruce M. Jolicoeur, MAI, a certified land appraiser in the States of Montana, Idaho and Washington, that the appropriate method of valuing riverbed lands is by reference to adjoining riparian lands.

For its part, PPL Montana employed Dr. Gary Saleba, another regionally known expert on utility economics, as its principal damages witness. His conclusions, although somewhat

different in method, were expected to be very similar to the conclusions of Dr. Zepp and Mr. Jolicoeur.

4. **Litigation Summary.**

The initial claims filed by the Private Plaintiffs were subsequently adopted by the State Attorney General and, as discussed below, were later reinforced by the rulings of the Montana District Court.

To defend the action, Avista retained, as joint counsel, the law firms of Paine Hamblen LLP of Spokane, Washington--a firm with extensive history representing both publicly and privately owned utilities, including in cases involving the shared net benefits methodology; and Garlington, Lohn & Robinson, PLLP of Missoula, Montana--a respected and long-established Montana law firm. PPL Montana and PacifiCorp, respectively, retained K&L Gates of Seattle and Stoel Rives LLP of Seattle as their primary counsel, as well as Montana-based counsel.

In response to the Complaint of the Private Plaintiffs, and similarly in response to the state court Complaint of the State of Montana, Avista initially moved the Federal Court to dismiss the action on the grounds that federal law preempts Montana law to the extent that the latter requires payment of rents by federally licensed Hydroelectric Owners. Additionally, Avista moved to dismiss the Private Plaintiffs for lack of standing. PPL Montana and PacifiCorp filed similar motions.

The Federal District Court ruled against the Hydroelectric Owners on the issue of federal preemption, but granted their motions to dismiss the Private Plaintiffs for lack of standing. Subsequently, the Hydroelectric Owners filed motions to dismiss the federal court action on the grounds that the Court lost jurisdiction of the matter when it dismissed the Private Plaintiffs. In response, the Federal Court dismissed the lawsuit and vacated its prior rulings.

Thereafter, in November 2004, the Hydroelectric Owners initiated a declaratory judgment action in Montana State District Court in Helena, Montana. In response, the State filed an Answer, Counterclaim and a Motion for Summary Judgment. Likewise, Avista, PPL Montana and PacifiCorp filed various motions asserting, among other things, the defenses of federal preemption, prescriptive easement, estoppel, laches, statute of limitations, waiver and breach of agreement. These motions were heard by the Montana District Court on June 28, 2005, at which time they were taken under advisement. In April 2006, the District Court ruled that (a) neither the Federal Power Act nor the Federal Navigation Servitude facially preempted the State from obtaining rental compensation under the Montana Hydroelectric Resources Act; and (b) that the Hydroelectric Owners' equitable defenses were unavailable against the State. In addition, the Court rejected Avista's attempts to assert the Clark Fork Settlement Agreement (an agreement involving Montana, Idaho and other stakeholders in the relicensing of Avista's Clark Fork Project) as a defense to the State's Counterclaim. The Court did, however, allow Avista to challenge the navigability of the Clark Fork River (later ruling, however, that it was navigable).

Following these decisions, the District Court established a procedural schedule for discovery, disclosure of expert reports and filing of dispositive motions. Trial was originally scheduled to begin, without a jury, on October 15, 2007. Between 2006 and 2007, the parties exchanged thousands of pages of documents in discovery, prepared and exchanged detailed expert reports and conducted 35 depositions of party representatives, experts and other witnesses.

In late 2006, a second series of motions for summary judgment and motions to exclude evidence were filed by the parties. In total, the parties filed over 1,300 pages of briefs, not including exhibits, on the many legal issues raised by the proceedings. In September and October, 2007, the Montana District Court issued orders on pending motions. Among other things, the District Court made the following determinations as a matter of law:



- a) The Clark Fork River is navigable for purposes of establishing the State's claim to title;
- b) The State owns the beds of the Clark Fork River and may charge rent to Hydroelectric Owners for their use;
- c) Riverbed lands are School Trust Lands;
- e) There are no statutes of limitation or equitable defenses that limit the State's claims with respect to School Trust Lands and, as a consequence, the State may seek damages back to the original construction of the dams at issue;<sup>3</sup>
- f) Because the lands in question are School Trust Lands, rents are owed by Hydroelectric Owners under the Montana Hydroelectric Resources Act for their use and occupancy;
- g) Water rights held by the Hydroelectric Owners do not preclude the State from seeking damages and rents;
- h) The State is not precluded from presenting evidence of its damages based upon a "shared net benefits" theory; and
- i) The State's damage claim is not limited to the physical footprint of the dam itself, but may extend to include the use of upstream riverbeds owned by the State.

The District Court also ruled that State's ownership interest extends only to the riverbed lands before the dams were built, and does not extend to lands that were subsequently inundated as a result of the Hydroelectric Owners' projects. This ruling was significant, as it diminished the potential recovery of the State by nearly two-thirds. Nonetheless, as a result of the District Court's other rulings, the State was granted the right to seek damages from Avista back to 1954.

Avista and PPL Montana sought interlocutory review of the District Court's rulings by the Montana Supreme Court. With one dissent, the Montana Supreme Court declined to exercise interlocutory jurisdiction, meaning that the parties would be forced to wait until a final judgment was entered before seeking appellate review of the District Court's rulings.

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<sup>3</sup> Although the Court had earlier addressed the statute of limitations as a defense, it had not considered Avista's additional argument that the Montana Code § 27-1-318, limits a party's relief for certain claims to five years. Significantly, the Court's subsequent decision on this issue against the Company (thereby exposing the Company to damages back to 1954) was received just hours after the settlement between Avista and the State was reached. If received earlier, it may have impacted the State's willingness to waive all of its claim for past damages.

As a result of the District Court's rulings in September and October 2007, the following issues remained to be determined at trial:

- a) The acreage of the State-owned lands at issue;
- b) The appropriate method for determining prospective rentals and retroactive damages; and
- c) The amount of such rentals and damages.

As stated before, the State's trial position, as set forth in the Pretrial Order entered with the Court, was that Avista owed \$200,374,752 in damages accruing back to 1954, and \$8,416,510 on an annual basis going forward, adjusted annually by the Consumer Price Index.

**5. Settlement Discussions and Mediation.**

Beginning in late 2006, Avista initiated a series of informal settlement discussions with the State<sup>4</sup>. In furtherance of those efforts, on September 6 and 7, 2007, a mediation was conducted in Helena, Montana by Jack Mudd, a respected former Dean of the University of Montana Law School. At that time, however, Avista and the State were unable to bridge the gap between the State's expected level of damages and Avista's settlement position. Informal discussions continued, and on October 17, 2007, representatives of Avista and the State met in Helena for a final effort, on the eve of trial, to arrive at a mutual settlement. This final round of negotiations resulted in a tentative settlement that was subsequently memorialized in a *Memorandum of Negotiated Settlement Terms*, dated October 19, 2007. A copy of that Memorandum is attached to the Petition as Appendix 2.

**6. Terms of Settlement.**

For purposes of settlement, Avista has agreed to pay rent to the State each year, beginning in the calendar year 2007, in the amount of \$4,000,000 per year. These rental

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<sup>4</sup> PacifiCorp settled with the State in June, 2007. The amount of the settlement in annual rentals is between \$50,000 and \$60,000, which reflects the very small size of the PacifiCorp project at issue (only 4 Mws.)

payments are to be made in arrears, with payment due on or before each February 1 for the previous calendar year. Rent will be adjusted each year by the Consumer Price Index (CPI) annual average for the calendar year for which payment is due. The State has agreed that the payment of such rent represents the full market value of Avista's use of the Clark Fork River. No later than June 30, 2016, Avista and the State will meet and confer to review the terms of the lease for the balance of the term of Avista's license, with advisory arbitration in the event of disagreement. As part of the settlement, the State has also agreed to waive its claim to past damages of \$200,374,752 in its entirety.

The parties have also agreed to jointly move the District Court to enter the terms of the *Memorandum of Negotiated Settlement Terms* as part of a final judgment in a Consent Decree.

7. **Favorable Aspects of the Memorandum of Negotiated Settlement Terms.**

The negotiated terms of the parties' settlement presents a favorable resolution to Avista of hotly contested matters, particularly taking into account the primary elements of the settlement.

These include the following:

- a) The negotiated annual rent on a prospective basis represents only 48% of the State's litigation position, as set forth in the Pretrial Order (\$8.4 million). Significantly, the State will also not receive any retroactive or historical damages, notwithstanding the Montana District Court's rulings that would have allowed evidence of such damages (the state was claiming \$200 million).
- b) Assuming that PPL Montana, which remains in the case, achieves a more favorable outcome at trial or through settlement, Avista will receive the benefit of that outcome. In particular, if the aggregate annual rent determined by settlement or litigation for PPL Montana is less than 48% of the base year rent claimed from PPL Montana by the State in its case-in-chief, Avista's aggregate annual rent will be decreased proportionally.
- c) If subsequent governmental action within Montana results in a rental payment more favorable to Avista than the rent calculated under the *Memorandum of Negotiated Settlement Terms*, the rent paid by Avista will be modified to incorporate the more favorable terms.

- d) If, during the term of Avista's FERC license, a court determines that i) the Clark Fork River is not navigable for title purposes, ii) the shared net benefits method is not a lawful method of calculating the full market value of land interests, or iii) no compensation or reduced compensation in the nature of rentals is owed to Montana for occupancy of State-owned riverbeds, and the application of such determination or determinations would result in a rental payment more favorable to Avista, or otherwise extinguish Avista's obligation of pay rentals, Avista's obligation to pay rent will be modified.

By virtue of these provisions, the *Memorandum of Negotiated Settlement Terms* insures to Avista and its customers the up-side benefits of any subsequent governmental actions or judicial determinations in Montana. Although these types of re-openers or off-ramps are uncommon in litigation, it is a fair accommodation to the interests of Avista and its customers in this case.

Finally, it should be remembered that the Montana Supreme Court is the author of the cases upon which the State's School Trust Land rental obligation is predicated. Moreover, any appeal from an unfavorable ruling by the Montana Supreme Court would have to be taken to the United States Supreme Court, which accepts review in only a small percentage of cases submitted to it, and which may be reluctant to interfere with the Montana Supreme Court's interpretation of its own state laws. Therefore, considering the risks of continued litigation, together with the limited potential for a successful appeal, the settlement reflects a reasonable compromise, and a fair accommodation to the interests of Avista and its customers.

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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DOCKET NO. UG-08 \_\_\_\_\_

EXHIBIT NO. \_\_\_\_ (DPV-4)

DENNIS P. VERMILLION  
REPRESENTING AVISTA CORPORATION

**Memorandum of Negotiated Settlement Terms**  
October 19, 2007

This memorandum outlines the key terms of the agreement in principle reached between Avista Corporation and the State of Montana to resolve all issues pending between them in Cause No. CDV 2004-846, Mont. First Judicial District Court, Lewis & Clark County.

1. **Rent.** For purposes of settlement Avista agrees to pay rent to the State each year beginning calendar year 2007, and continuing through the remaining term of Avista's FERC license for the Clark Fork Project. Avista acknowledges that the State owns 3,158 acres of riverbed within the Clark Fork Project. The State acknowledges that the rent represents the full market value of the State interest or estate being used by Avista in connection with its operation of the Clark Fork Project (which includes both the Noxon Rapids project, and that portion of the Cabinet Gorge project within Montana). Rent will be paid in arrears, with payment due on or before each February 1 for the previous calendar year. The initial amount of the rent will be \$4 million per year. The rent will be adjusted each year as follows:

a. Beginning with calendar year 2008, and continuing through calendar year 2016, the base amount of \$4 million per year shall be adjusted upward by the Consumer Price Index (CPI) annual average for the calendar year for which payment is due.

b. Not later than June 30, 2016, the parties will meet and confer to determine whether the annual rental remains consistent with the principles of law as applied to the facts. In the event either party believes the annual rental no longer is consistent with applicable law applied to the facts, the parties will negotiate in good faith to determine an appropriate adjusted rental rate. If the parties do not agree upon an adjusted rental rate by September 30, 2016, the parties will engage in advisory arbitration and submit the arbitrator's recommendation to the State Board of Land Commissioners ("Land Board") for approval.

2. **Lease Terms.** The parties agree to jointly recommend to the Land Board a lease of a power site pursuant to the provisions of the Hydroelectric Resources Act, Mont. Code Ann. §§ 77-4-201, *et seq.* As part of that recommendation, the State and Avista agree to stipulate that the rent agreed upon by the parties represents full market value for the lease of 3,158 acres of Clark Fork riverbed being used by Avista in connection with the Clark Fork Project. The duration of the lease will be not less than the remaining term of Avista's FERC license.

3. **Most Favored Nations Clause.** If co-party PPL Montana, LLC, either by litigation through judgment and any appeals, or through settlement, receives a determination that the full market value of its land interests at issue in the litigation is based upon factors more favorable to it than those contained in the settlement with

Avista, the Avista rent will be adjusted by an amount necessary to reflect the more favorable determination. For purposes of this clause, a more favorable determination will occur if the aggregate annual rent determined by settlement or litigation for PPL Montana ("Determined PPL Rent") is less than 48% of the aggregate amount of base year rent ("Claimed PPL Rent") claimed by the State in its case in chief at trial. If this occurs, the \$4 million base rent to be paid by Avista shall be reduced retroactively starting on the date of final judgment on the PPL Montana claims or settlement by a percentage equal to the Determined PPL Rent divided by the Claimed PPL Rent. See Attachment A for an illustration of the calculation.

4. **Reopener for Subsequent Governmental Action.** If, during the term of the Avista lease, the Land Board, the Montana Legislature, the Department of Natural Resources and Conservation, or any other State entity with jurisdiction, enacts or adopts a rental statute, rule, or policy applicable to leases issued under the Hydroelectric Resources Act that would result in a rent payment more favorable to Avista than the rent calculated under paragraph 1, the rent paid by Avista shall be modified retroactively starting on the date of enactment or adoption to incorporate the more favorable terms.

5. **Reopener for Subsequent Judicial Determination.** If, during the term of the Avista lease, the reach of the Clark Fork River within the boundaries of Avista's FERC license is determined by a court of competent jurisdiction to be not navigable for title purposes, Avista's obligation to pay rent shall cease. If, during the term of the Avista lease, a court of competent jurisdiction determines that (a) the shared net benefits method is not a lawful method to calculate the full market value of land interests; or (b) no compensation or reduced compensation in the nature of rentals is owed to the State of Montana for occupancy of state-owned riverbeds, and the application of such determination or determinations would result in a rent payment more favorable to Avista than the rent calculated under paragraph 1, or otherwise extinguish Avista's obligation to pay rentals, Avista's obligation to pay rent will be modified retroactively starting on the date of determination to reflect a method of calculating rent that is consistent with the court determination or determinations, or Avista's obligation to pay rent shall cease, accordingly.

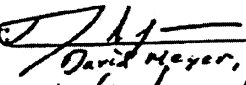
6. **Consent Decree.** The parties will agree on the form for, and jointly move the entry as a final judgment of, a consent decree that: (a) incorporates the terms of this Memorandum; (b) contains full releases of Avista and the State for all matters at issue in the litigation; (c) allows for appropriate public notice and comment; (d) certifies that Avista is in full compliance with the terms of the Hydroelectric Resources Act; and (e) includes appropriate other terms such as dispute resolution, force majeure and so forth.

STATE OF MONTANA

AVISTA CORPORATION

By:   
ANTHONY J. STONESTROM, ASST. A-G.

Date: OCT. 19, 2007

By:   
David Meyer, V.P. and Chief Counsel for  
Regulatory/Governmental  
Affairs

Date: 10/19/07

**ATTACHMENT A**

If the Determined PPL Rent is less than 48% of the Claimed PPL Rent, Avista annual rent shall be recalculated according to following formula:

Annual Recalculated Avista Rental =  $A \times (D + C)$  Where:

A = \$8,416,510 (Amount of annual rent claimed by the State in the State's Contention 9.A of the Pretrial Order)

D = Determined PPL Rent

C = Claimed PPL Rent set forth in State's case in chief

As an illustration, if Determined PPL Rent is \$3,000,000, and the Claimed PPL Rent is \$7,252,804, the Annual Avista Rental would be calculated as follows:

Annual Recalculated Avista Rental:  $\$3,481,347 = \$8,416,510 \times (\$3,000,000 \div \$7,252,804)$



**REDACTED**

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**DOCKET NO. UE-08\_\_\_\_\_**

**DOCKET NO. UG-08\_\_\_\_\_**

**EXHIBIT NO. \_\_\_\_ (DPV-5)**

**DENNIS P. VERMILLION**

**REPRESENTING AVISTA CORPORATION**

**CONFIDENTIAL per WAC 480-07-160**

**Avista Utilities Energy Resources Risk Policy**

**Pages 1 through 25**