BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of	)	
	)	
AVISTA CORPORATION (d/b/a AVISTA UTILITIES),	)	
	)	DOCKET NO. UG-060518
For an Order Authorizing Implementation of a Natural Gas Decoupling Mechanism and to Record Accounting Entries Associated With the Mechanism	)	

PRE-HEARING BRIEF OF SETTLEMENT PARTIES

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1 Avista Corporation (hereinafter "Avista" or "Company"), the Washington Utilities and Transportation Commission Staff ("Staff"), and the NW Energy Coalition (the "Coalition"), hereinafter jointly referred to as the "Signing or Settling Parties," respectfully submit this Pre-Hearing Brief addressing Avista's proposed Decoupling Mechanism ("Mechanism").[1]

I. INTRODUCTION

2 On April 4, 2006, the Company filed a Petition requesting the Commission approve a proposed natural gas Decoupling Mechanism. Various workshops were held with interested parties, resulting in amendments to this filing, as discussed in more detail below. Ultimately, a Settlement was reached with a number of parties, which included the Company, Staff, NWIGU, and the Coalition. That Settlement Agreement has been attached as an exhibit to the Joint Direct Testimony of the Signing Parties. Neither Public Counsel nor The Energy Project joined in the Settlement.

3 Under WAC 480-07-750(1), the Commission will approve settlements:

> . . . when doing so is lawful, the settlement terms are supported by an appropriate record, and when the result is consistent with the public interest in light of all of the information available to the Commission.

When addressing a proposed settlement, the Commission "must determine one of three possible results: (1) Approve the settlement without condition; (2) Approve the proposed settlement subject to condition(s); or (3) Reject the proposed settlement." *See* Order No. 05, "Approving and Adopting Settlement Agreement With Conditions," (Docket No. UG-050482/UG-050483) (December 21, 2005) at pp. 9-10, para. 19 (citing WAC 480-07-750(2)). Should the Commission reject the proposed settlement, or otherwise impose

[1] The Northwest Industrial Gas Users (NWIGU) also joined in the Settlement as a Signing Party but will be submitting its own brief.

conditions that are unacceptable to the parties, the Commission's rules "provide that the proceeding will return to its posture as of the day before the settlement was filed." (Order, *supra*, at p.10, para. 21) Accordingly, the Commission "will conduct further process, if any is required, to allow fully adjudicated results considering the parties' respective litigation positions and due process rights." (*Id.*)

4 As the following Brief will demonstrate, this proposed Settlement satisfies the Commission's "three-part inquiry." (Order, *supra*) It is 1) not "contrary to law," 2) does not "offend public policy" and 3) is supported by the evidence "as a reasonable resolution of the issue(s) at hand." (Order, *supra* at para. 18)

5 The remainder of this Pre-Hearing Brief will discuss the history of this filing, including the considerable efforts expended by the parties, over time, to narrow the issues and arrive at a settlement concerning decoupling. It will also explain why the Settlement is in the "public interest" and why it benefits customers. The Brief will begin with a description of the Company's DSM Programs, demonstrating its commitment to further the objective of conservation. It will then provide an overview of the Mechanism itself, *i.e.*, how it is constructed, how and when rate adjustments are made, and what safeguards are in place to assure that the objectives are being met and that the Mechanism is accomplishing what it is designed to do.

6 As explained in the Joint Direct Testimony (hereinafter "JDT") filed in support of the Settlement, the increase in the cost of natural gas over the past several years makes consideration of a natural gas Decoupling Mechanism "especially important at this time." (JDT, p.7, ll. 5-6) Accordingly, given the increased cost of natural gas and projections of high prices continuing into the future, it is "increasingly important to focus on effective

long-term efficiency and conservation measures." (*Id.* at ll.8-14) Avista's current rate structures, however, provide for the recovery of the majority of its fixed costs on a per-therm (sales volume) basis; therefore, energy efficiency and conservation objectives are "directly at odds" with the recovery of the fixed costs of providing service. (*Id.*) This prompted the proponents of the Settlement, in their Joint Direct Testimony, to conclude that it is important to "break the link between the volume of therm sales and the recovery of fixed costs and . . . provide for an increased focus on energy efficiency and conservation." (*Id.*) The Signing Parties stated their belief that the Settlement will "serve the broader interest of removing disincentives to engage in additional conservation." (*Id.* at p.7, ll.15-17)

7 Because the Settlement would further serve to promote energy efficiency and conservation, not only will individual customers participating in DSM measures benefit through reduced bills, but all customers would benefit through the reduced overall demand for natural gas, resulting in natural gas prices that would be lower than they otherwise would have been. (*See* JDT, at p.7, l.20 – p.8, l.2) As a result, the overall "public interest" is served. The phenomenon of decreased natural gas usage per customer is very real with respect to Avista's system. From 1999 to 2005, the Company's Washington residential and small commercial gas customers have reduced their average usage by 13.5 percent, on a weather-corrected basis, as is testified to by Mr. Hirschkorn. (Hirschkorn Direct, p.4, ll.5-9) Mr. Hirschkorn will explain that Avista has implemented two natural gas general rate increases for Washington customers since 2004, a "primary cause" of which was the reduction in customer usage that resulted in an under-recovery of fixed costs (*i.e.*, margin). (*Id.*) As further explained by Mr. Hirschkorn in his pre-filed direct testimony:

> The rates established in a general rate proceeding are designed to provide full recovery of the costs of providing service to customers. When the majority of fixed costs are recovered through sales volumes, and sales volumes are lower than expected, the recovery of fixed costs falls short of the level authorized by the Commission. An effective decoupling mechanism, which separates the recovery of fixed costs from sales volumes, is consistent with the ratemaking objective of authorizing rates that are designed to recover the fixed costs of providing service.

(*Id.* at p.4, ll.10-16) As further explained in the Joint Direct Testimony of the Signing Parties, the Mechanism would "align the Company's interest with that of its customers with an increased focus on effective DSM programs." (JDT, p.8, ll.8-12) In the Settlement, the key component is that the level of "lost margin" recovered through the Mechanism will be directly tied to the Company's ability to achieve certain "target" levels of natural gas DSM savings. (*Id.*) In this manner, not only will the Mechanism address the so-called "lost margin" issue, but in doing so, it will provide incentives to achieve cost-effective DSM savings.

II. HISTORY OF EFFORTS CULMINATING IN THE SETTLEMENT

8 When the Company filed its Petition in April 2006 requesting approval of the Mechanism, it provided a copy to representatives of a number of different constituencies; these included the Office of Public Counsel, the Northwest Industrial Gas Users, the NW Energy Coalition, the Washington Energy Policy Group (Department of Community Trade and Economic Development or "CTED"), and the Spokane Neighborhood Action Program. Shortly thereafter, a workshop was held on May 17, 2006, in order to discuss the Company's proposed Mechanism. All of the aforementioned organizations who had been provided a copy of the Petition were present, as was a representative of The Energy Project. This workshop provided an opportunity for the Company to explain its Mechanism, respond to

questions and receive suggestions from the other parties. (*See* JDT, p.5, l.20 – p.6, l.8) A subsequent workshop was held on June 28, 2006, in the Commission's offices, to further discuss any outstanding issues regarding the Mechanism, at which time a number of different issues and alternatives were explored. As part of this process, the Company responded to a variety of informal data requests from Staff, Public Counsel, and the Coalition. (*Id.*)

9 Based on the extensive discussion of the issues in the prior workshops, the Company filed an Amendment to its original Petition on August 7, 2006, in order to address a variety of issues raised by the parties. Accordingly, the Amendment served to 1) revise the proposed effective date of the Mechanism; 2) refine the determination of new customer usage as applied in the monthly revenue deferral calculation; 3) revise the DSM achievement levels used to determine the level of recoverable deferred revenue recorded under the Mechanism; 4) provide for further evaluation of the Company's annual DSM results; and 5) set forth a process for evaluation of the Mechanism. (*Id.* at p.6, ll.9-18) During this entire process involving workshops, responding to information requests and making revisions to the Company's filing, there was ample opportunity for all parties to explore the issues, provide alternative recommendations, if any, and fine-tune the proposal. Simply put, a lot of hard work has gone into developing the decoupling proposal that is now before the Commission.

10 Finally, on October 16, 2006, a settlement conference was held. Attending were representatives of the Company, the Staff, Public Counsel, the NW Energy Coalition, the Northwest Industrial Gas Users, and The Energy Project. That settlement conference culminated in the Settlement Agreement that is being proffered for Commission acceptance.

It is the result of extensive efforts by the parties and the fine-tuning of the proposal, producing a Mechanism that the Signing Parties believe is a well-defined and straightforward decoupling proposal. As explained by the Signing Parties in their pre-filed Joint Direct Testimony:

> The Settlement Agreement represents a compromise among differing points of view. Concessions were made by all Signing Parties to reach a reasonable balancing of interests. As will be explained in the following testimony, the Settlement Agreement received significant scrutiny and is supported by sound analysis and sufficient evidence. Its approval is in the public interest.

(JDT, p.5, ll.6-10) The balance of this Brief will explain why this Settlement is in "the public interest."

III. DESCRIPTION OF AVISTA'S DSM EFFORTS

11 It is important to first place the Settlement into the context of Avista's DSM efforts. The Company has had a natural gas DSM program in place beginning in the mid-1990s, and, as explained in Mr. Hirschkorn's pre-filed direct testimony, it has worked closely with other stakeholders on DSM policy and programs. (Hirschkorn Direct, p.6, ll.7-16) Funding for these programs has been provided through the DSM tariff rider approved by the Commission in 1995. Avista strives to be a leader in the Northwest in implementing and supporting DSM programs. (*Id.*) As will be discussed below, the proposed Decoupling Mechanism would align the Company's interest with that of its customers with an increased focus on effective DSM programs. The level of any "lost margin" recovered through the Mechanism will be tied directly to the Company's achievement of certain "targeted" levels of natural gas DSM savings. (*Id.*)

12 Avista Witness Powell, who serves as a Manager within the DSM Department of Avista, describes the scope of the Company's DSM portfolio in his pre-filed testimony.

(*See* Powell Direct, p.6, l.20 – p.7, l.16) He explains that the DSM portfolio relies upon a combination of technical assistance and direct financial incentives to encourage natural gas efficiency.[2] For example, in calendar year 2005, over 150 non-residential natural gas projects and 2,000 residential natural gas projects received direct incentive assistance. Commercial and industrial customers benefitted from site-specific programs, with broad eligibility for every commercially-proven natural gas efficiency measure. For their part, residential customers have a variety of natural gas efficiency programs available to them. As will be explained by Mr. Powell, these include incentive-based programs for high-efficiency furnaces, high-efficiency water heaters, ceiling/wall/floor insulation, duct insulation, and energy-efficient windows. Moreover, limited-income customers are eligible to receive additional funding on an expanded array of measures handled under a contract with the Community Action Agencies, as funded through the Company's DSM program. (*Id.* at p.7, ll.6-16)

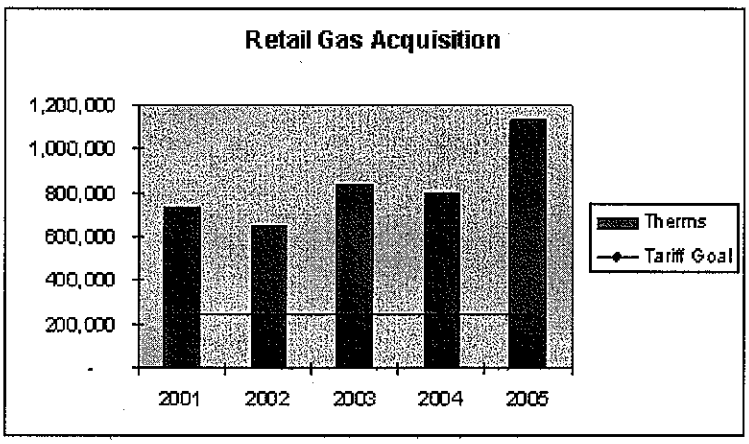
13 Mr. Powell also describes the Company's future initiatives to capture additional DSM savings; these include additions to technical staff to serve the commercial/industrial programs, as well as a variety of individual programatic measures. (*Id.* at p.7, l.19 – p.8, l.9)

14 The Company's DSM efforts benefit from substantial oversight by an external group known as the External Energy Efficiency (Triple E) Board, which provides guidance with respect to the implementation of DSM programs. This Board is composed of regulators, critical stakeholders and key customers interested in the success of the Company's DSM programs. Both annual and quarterly reports covering portfolio measures are issued by the Board in the form of "Triple E Reports," an example of which is attached to Mr. Powell's

[2] As explained by Mr. Powell, the Company has been very efficient in the expenditure of its funds, with 82 percent of the $3.0 million expended for the natural gas efficiency programs provided to customers in the form of direct incentives. (Powell Direct, p.6, l.22 – p.7, l.2)

direct testimony. (*See* Powell Direct, p.8, l.14 – p.9, l.2) These reports serve to analyze expenditures, levels of resource acquisition and avoided cost values for each component of the DSM portfolio.

15 The Decoupling Mechanism, as discussed below, employs a DSM acquisition goal of 1,062,000 therms (for the combined Washington and Idaho jurisdictions), based on the 2006 Integrated Resource Plan (IRP) recently filed with, and recognized by, this Commission. As will be explained by Mr. Powell, this IRP process is a comprehensive biennial evaluation and ranking of supply-and-demand resource opportunities. While the Company achieved the 1,062,000 therm goal in 2005, it is well to remember that this goal is 15 percent higher than the average of the most recent three year period, as shown in the illustration below, excerpted from Mr. Powell's pre-filed testimony at page 4:



Mr. Powell, elsewhere in his pre-filed testimony, attempted to put these recent DSM results in perspective:

> In the nearly five years since Avista reinitiated its natural gas DSM programs, the Company has been uncertain whether customer interest would continue to suggest this level of acquisition. Given the lack of historical precedent, it has not been possible to determine if this is a one-time response to acquire measures that have become cost-effective at higher retail rates, or if it will be a sustained response for the foreseeable future. Based on five years of experience and the analytical results of this IRP, however, the Company is proceeding on the presumption that this is a sustainable level of acquisition.

(Powell Direct, p.5, ll.9-14)[3] Hence, the parties are well aware of the challenge of maintaining – and building upon – those levels of DSM acquisition.

IV. OVERVIEW OF DECOUPLING MECHANISM

A. The Mechanism is Straightforward and Easily Understandable.

16 As explained in the pre-filed Joint Direct Testimony, the Mechanism is "relatively easy to understand and implement, directly ties the recovery of loss margin to both an annual earnings-test and pre-established DSM targets, and provides adequate time for audit prior to implementing any rate adjustment." (JDT, p.8, ll.15-20.) The Mechanism includes a straight-forward calculation of a monthly deferred revenue amount, reflecting a defined percentage of the difference between the weather-corrected margin (revenue less purchased gas costs) and the level of margin for the corresponding month of the test year approved by the Commission in the Company's last general rate case. Any annual rate adjustment resulting from the Mechanism would be implemented at the time of the annual PGA adjustment, and would be limited to no more than a two percent rate increase or decrease. (*Id.* at p.9, ll.1-4) The Mechanism, by its terms, would only apply to the Company's natural gas Schedule 101, which includes residential and small commercial customers who comprise over 98 percent of the Company's customer base. (*Id.* at p.9, ll.5-7)

[3] Total expenditures for both Washington and Idaho gas DSM programs for 2001 through 2005 totaled $8,363,067 (Powell Direct, p.5, ll.17-18).

17 Under the terms of the Settlement, the implementation of the Mechanism would begin on January 1, 2007, whereby deferred revenue entries would begin being recorded for that month.[4] The term of the pilot program would extend for two years and six months for the recording of deferred revenue (January 2007 to June 2009), although the proposed amortization period would remain at three years, *i.e.*, beginning Fall 2007 and ending Fall 2010. (*Id.* at p.9, ll.10-15)

18 The calculation of the monthly deferral (*see* Section 6.C of the Settlement) is described at pages nine to 11 of the pre-filed Joint Direct Testimony, but involves "essentially five simple steps":

Step 1 – Subtract new customer usage from total actual usage;

Step 2 – Weather-correct net usage[5];

Step 3 – Calculate difference in usage between current month and test year;

Step 4 – Calculate the margin difference resulting from the usage difference;

Step 5 – Record deferred revenue for 90 percent of the margin difference.

See JDT p.11, ll.9-15. Every month, the margin difference between the current month and the corresponding month of the test year is calculated and 90 percent of the difference is recorded as deferred revenue.

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[4] Because the Company would not make any calculations under the Mechanism for the month of January until early February, as long as the Commission issues its order on the Settlement prior to that time, the Mechanism could still become effective as of January 1, 2007. (*See* JRT, p.14, ll. 12-14)

[5] While the Company would continue to use the 2004 test period usage as the "base therm sales" for purposes of calculating the monthly deferred revenue, should the Company subsequently file a natural gas general case, the approved test year therm usage and Schedule 101 margin rate from that filing would be used to calculate deferred revenues for the remaining months of the proposed term. Similarly, any weather adjustment approved in that filing would be used for determining the "base therm sales" and "current therm sales." (Joint Direct Testimony, p.11, ll.18- p.12, l.4)

19 In the process, it is well to remember that the proposed Mechanism captures only the changes in residential and commercial customers' usage resulting from natural gas conservation, energy efficiency and price elasticity. As explained by Mr. Hirschkorn, it does not otherwise capture changes in large customer usage resulting from business or economic conditions or changes resulting from abnormal weather. Accordingly, Mr. Hirschkorn will testify that:

> These changes in customer usage that are not included in the Company's Mechanism can be more substantial and affect the Company's business risk going forward. By excluding the variation in sales volume/margin caused by abnormal weather, the Company is still retaining the majority of risk associated with sales variability.

(Emphasis added) (Hirschkorn Direct, p.5, ll.9-15) Because of the way the Mechanism is structured by first removing the effects of abnormal weather, it will not significantly affect the Company's business risk going forward. Stated differently, the Company will still bear the business risk of variations in weather and changes in large customer usage due to business or economic conditions.

B. The Mechanism Has Built-In Safeguards to Protect Customers and Assure that Objectives Are Being Met.

20 As explained in the pre-filed Joint Direct Testimony, the Company would implement a decoupling rate adjustment coincident with the PGA in the Fall of 2007 only if: 1) it did not "over-earn" for its Washington gas operations during 2006 (*i.e.*, the so-called "earnings test"), and 2) if it meets certain pre-established gas DSM savings targets during 2006. (JDT, p.12, ll.18-21) These are among the "safeguards" built into the program that are designed to

protect the customer, while at the same time promoting DSM efforts,[6] in each year of the pilot Mechanism.

1. Application of the "Earnings Test."

21 As explained in the pre-filed Joint Direct Testimony, the "earnings test" would be based on the Company's annual "commission-basis" operating results which are filed by April 30 for the previous calendar year results. Should the "Commission-basis" rate of return for Washington gas operations exceed 9.11 percent for 2006 (the Company's currently authorized rate of return), the Company would reduce the amount of the proposed surcharge to bring the rate of return down to 9.11 percent. (*Id.* at p.13, ll.6-13) (If removing the entire deferred revenue amount from the Commission-basis report does not reduce the rate of return to 9.11 percent, then no surcharge would be implemented.[7])

2. Application of the "DSM Test."

22 This second test provides financial incentives to the Company to meet certain pre-established natural gas DSM savings targets. The initial savings target of 1,062,000 therms was derived from the Company's 2006 Integrated Resource Plan (IRP), as discussed above. This level of savings will be used for determining the 2007 and 2008 surcharges, if any. Subsequently, the Company's 2008 IRP will be used for any 2009 surcharge. (JDT, p.14, ll.5-15) The following table has been excerpted from the Settlement (*see* Section 6.E.(2)) and serves to illustrate the level of the surcharge (expressed as a percentage of the margin

[6] The "earnings test" and the "DSM test" would be repeated for subsequent years under the pilot program based on earnings and DSM results for 2007 and 2008. (JDT, p.13, ll.1-3)

[7] Where the amount of the surcharge is reduced as a result of the earnings test, the cumulative amount of the deferred amount remaining from the prior year will be carried forward and used to offset future deferrals, rather than written off the Company's books. (JDT, p.13, ll.16 – p.14, l.2) (*See also* Attachment 1 to the Settlement Agreement, providing an illustration of this impact.)

difference between the current year and the test year), based on actual gas DSM savings compared to target savings:

Actual vs Target DSM Savings	Surcharge vs Margin Difference
< 70%	0%
≥ 70% and < 80%	60%
≥ 80% and < 90%	70%
≥ 90% and < 100%	80%
≥ 100%	90% (amount deferred)

The Joint Direct Testimony, at page15, lines 8 to 22, describes how this DSM test would work under various scenarios, including where the Company exceeds 100 percent of the target level, fails to achieve 70 percent of the target or otherwise falls somewhere in between. It is important to remember that the "earnings" and the "DSM tests" are calculated independently, and whichever test results in the lowest surcharge amount will be used. (*Id.* at p.16, ll.3-6) Attachment 2 to the Settlement provides various examples of the application of the "earnings" and "DSM" tests.

3. Application of the "2% Cap."

23 Even after applying the "earnings" and the "DSM" tests, any rate increase resulting from the Mechanism would still be subject to an annual incremental limit of two percent (2%) (rate increase or decrease); in other words, the annual increase in the surcharge cannot exceed a two-percent rate increase (or decrease) each year, for a cumulative effect not greater than six percent over the three year term of the pilot. (JDT, p.17, ll.10-21) Should the incremental surcharge exceed a two percent rate increase, only a two percent increase would be implemented and any excess deferred revenue would remain in the deferred revenue account, subject to recovery in the following year, again subject to the two percent limitation. (*Id.*)

24 The Company performed a "simulation" of the deferred revenue amount for the period July 2005 to June 2006, as if the Mechanism had been in place, resulting in a deferred revenue amount of $752,000.[8] Recovery of this amount over a 12-month period would result in a rate increase of approximately 0.4 percent over present rates in effect. (Hirschkorn Direct, p.11, ll.5-8)[9]

4. Audit/Program Evaluation.

25 In order to allow for ongoing review of the Mechanism, the Company will file a quarterly report with the Commission showing pertinent information, such as the monthly revenue deferral calculation for each month of the current deferral period, as well as the current and historical monthly balance of the deferral account. In addition, the Settlement provides (*see* Section 6.J.) that during the first year of the Mechanism, the Company, Staff and other interested parties will develop a Draft Evaluation Plan to be presented to the Commission no later than December 31, 2007. (*See* JDT, p.20, ll.4-7)

26 Moreover, the parties have agreed to retain an independent third party to audit the results of DSM savings reported for decoupling purposes. This audit will include a sampling of projects to verify completion of work, as well as the recorded savings and a review of the engineering estimates used to predict the savings. (JDT, p.16, ll.12-18)[10]

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[8] After reflecting further modifications to the Mechanism to exclude Schedule 111 customers, the deferred revenue amount in the simulation would be further reduced to $617,000. (*See* JRT, p.7, ll.18-20)

[9] A 0.4 percent increase would increase the monthly bill by $0.35 for a typical customer using 70 therms per month. For the 2,500 low-income customers that receive LIRAP assistance during the past year, their average usage was 59 therms per month; accordingly, a 0.4 percent increase would increase their monthly bill by $0.29. (Direct Testimony of Hirschkorn, p.11, ll.11-15)

[10] The settlement proposes to change the present method of recognizing DSM savings for decoupling reporting purposes to one where all savings associated with the project are recognized at the time the entire project is completed; this should "substantially reduce the cost" of a third party audit, without otherwise affecting the DSM goals used for decoupling. (JDT, p.17, ll.2-6)

27 Finally, and most importantly, it should be recognized that this Mechanism is a "pilot" program. That is to say, it will, by its terms, terminate at the end of its initial three-year term. Should the Company wish to extend it, it will need to support that request with an evaluation of the Mechanism developed as a result of the Draft Evaluation Plan (*supra*). Moreover, at that time, all parties and the Commission will have the benefit of nearly three years' worth of experience, coupled with quarterly reports, a program evaluation, and independent third party review of DSM savings.[11]

V. THE CONCERNS OF PUBLIC COUNSEL AND THE ENERGY PROJECT ARE MISPLACED

28 In their pre-filed testimony, Public Counsel, through the pre-filed testimony of Mr. Steven Johnson, and The Energy Project, through the testimony of Mr. Charles Eberdt, raised certain issues that will be addressed through the Joint Rebuttal Testimony of the Settling Parties. These issues include:

A. DSM Target Levels.

29 Public Counsel and The Energy Project contend that the Company is not committing to "incremental conservation" above and beyond what it is already achieving. As explained, however, in the Joint Rebuttal Testimony, the Mechanism provides for a "meaningful and elevated savings target" for the Company's programs. (*Id.* at p.2, ll.9-16) As previously discussed, the annual target of 1,062,000 therms was arrived at through the Company's 2006 Natural Gas Integrated Resource Plan. (*Id.*) This Plan involved a comprehensive

[11] On or before September 1, 2007, the Company will file a proposed decoupling surcharge (or rebate) based on the amount of deferred revenue recorded for the prior January through June 2007. The results of the "earnings," "DSM" and "2%" test will be included with the filing and used to determine the amount of the rate adjustment. A sample tariff that will be included in those filings is included as Attachment 3 to the Settlement. This proposed tariff would reflect a rate adjustment that would recover the deferred revenue amount over a 12-month period to be implemented coincident with the Company's annual PGA. (JDT, p.18, ll.3-21)

assessment of natural gas efficiency measures and was well received by the Commission.[12] Accordingly, the Mechanism relies on target levels established in the 2006 IRP as a basis for the "DSM test."

30 It is also well to remember that this target is 15 percent higher than the average savings of the most recent three-year period. (JRT at p.2, ll.12-16) Accordingly, both Staff and the NW Energy Coalition have joined with the Company in submitting rebuttal testimony that characterizes this as "a responsible commitment to energy efficiency," especially when coupled with the oversight responsibility of the External Energy Efficiency (Triple-E) Board. (*Id.*)

31 Public Counsel, through Mr. Johnson's pre-filed testimony (*see* p.9), also contends that the inclusion of January 2007 to June 2008 deferral amounts in rates provides "no incentive for a change in Company behavior." This ignores the fact that the Company has already increased its focus on DSM during 2006, due in part to the potential of a financial incentive associated with achieving the 2006 IRP goal as part of any approved Decoupling Mechanism. (*See* JRT at p.6, l.20 – p.7, l.9) (It will be recalled that the Mechanism was originally filed on April 4, 2006, and included the proposed IRP goal of 1,062,000 therms during 2006 to be used as the DSM test for any 2007 rate adjustment.) (*Id.*) As further explained in the Joint Rebuttal Testimony, the Company has devoted additional resources to

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[12] In the Commission's September 7, 2006 letter from Carole J. Washburn to the Company regarding its 2006 Integrated Resource Plan, the Commission noted:

> Avista has significantly improved both its methodology for assessing DSM as a resource option and the integration of DSM resources in its portfolio. A significant improvement was the inclusion of a comprehensive set of potential energy efficiency measures that were tested in the model and used to create a conservation supply curve . . .. Overall, the Commission commends Avista for the improvements it made to its DSM analysis.

(See Joint Rebuttal Testimony at p.3, ll.10-15)

achieving higher DSM goals in 2006 and beyond, including the creation of a new position of "Senior Manager" with responsibility for supervising the entire DSM area. Moreover, there has been a recent increase in the Company's natural gas DSM rider to fund a higher gas DSM budget. (*Id.*)

32 Mr. Johnson next argues, at page 14 of his pre-filed testimony, that there is no financial incentive for the Company to exceed the 100 percent of the annual target. He then suggests the Company could "delay" additional conservation until the following year. The Joint Rebuttal Testimony explains why this would not be in the best interests of the proponents of the Mechanism. Any continuation beyond the three year pilot program will be based on an analysis of the Company's DSM performance and a review of specific results that would reveal any "gaming" of the results. (*Id.* at p.10, ll.6-15)

B. Customers Will Not Pay Twice for Conservation.

33 Mr. Eberdt, on behalf of The Energy Project, suggests that customers will pay twice for conservation with the proposed Decoupling Mechanism. The Joint Rebuttal Testimony explains why this is not so. (*See* JRT at p.4, l.12 – p.5, l.2) Under the Mechanism, any decoupling rate adjustment would serve to recover only the fixed costs associated with providing service that was authorized in the most recent general rate case, and customers otherwise only pay once for the conservation program costs through the tariff rider (Schedule 191). (*Id.*) Of course, the alternative is to provide for the recovery of fixed costs through higher basic charges, which in turn, however, would have a larger billing impact on individual customers (particularly low-income customers). (*Id.*)[13] With the decoupling mechanism, customers maintain the benefit of lower bills that come from conservation, and

[13] It would also reduce the bill savings the customers might achieve through conservation efforts since less of the bill is subject to the household's usage. (JRT at p.4, ll.18-20)

any bill impact because of lost margin will be smaller because it is spread over the entire class. (*Id.*)

C. Margin Revenues Derived by Company from New Customers Between Rate Cases.

34 Public Counsel, through Mr. Johnson's testimony at page 6, argues that Avista's shareholders retain margin revenues derived from new customer use that occurs between rate cases, suggesting that this results in unnecessary short term profits to the Company. It should be remembered that: a) while the Company does receive margin from new customers, it also must bear the incremental fixed costs to provide service to such customers, as explained in the Joint Rebuttal Testimony (p.5, ll.7-16); and b) this result also occurs under current ratemaking, so the Settlement produces no incremental harm. In the final analysis, however, the Mechanism contains an "earnings test" that prevents the Company from realizing earnings that exceed the authorized levels by this Commission, as the result of the Mechanism. (*Id.*)

D. Size of Deferral in Relationship to Lost Margins.

35 Mr. Johnson, at page 7 of his pre-filed testimony, suggests that the deferrals under the Mechanism are "far out of proportion to the lost margins" from Avista's own DSM programs. Mr. Johnson fails to recognize that the Mechanism is designed to capture up to 90 percent of the lost margin resulting from <u>all reductions</u> in usage by Schedule 101 customers – even conservation beyond that which results from the Company's sponsored DSM programs, per se. (*See* JRT at p.6, ll.1-13) The intent is to encourage customers to conserve not only through programatic DSM, but also to achieve additional conservation through increased customer education and awareness. (*Id.*) With a Decoupling Mechanism, the Company will be given a "reasonable opportunity to recover lost margin due to all

conservation and can continue to encourage customers to conserve natural gas through education, as well as through programatic DSM," as explained in the Joint Rebuttal Testimony. (*Id.*)

E. Public Counsel Exaggerates the Projection of Deferred Revenues.

36 Public Counsel's witness Johnson, at page 8 of his pre-filed testimony, projects deferred revenue for the July 2007 to June 2008 period of $1.444 million. He has, however, improperly extrapolated from certain historical results reaching back to 1999 in order to achieve his estimate. In response to discovery from Public Counsel in this proceeding, the Company has provided an estimate of $650,000 as the total deferral amount for calendar year 2007, which is less than half of Mr. Johnson's estimate of $1.444 million. (*See* JRT at p.7, ll.13-20) This recent estimate of the Company is quite close to the prior simulation of the Mechanism performed by the Company for July 2005 to June 2006, which demonstrated $617,000 of deferrals, based on actual results. (*Id.*)

F. Exclusion of Schedule 111 Customers and Inter-Schedule Migration.

37 Mr. Johnson, at page 11 of his pre-filed testimony, questions the removal of Schedule 111 customers from the Mechanism. While Schedule 111 customers were originally included within the Mechanism, it became apparent, upon closer examination, that a significant number of large commercial and industrial customers have gas usage that can vary substantially because of economic conditions, as explained in the Joint Rebuttal Testimony. (*Id.* at p.8, ll.6-11) Accordingly, because of the difficulties of identifying, tracking and otherwise eliminating the usage of those customers from the Mechanism, the Settling Parties agreed to simply eliminate Schedule 111 from the pilot program. (*Id.*)

38 Moreover, Mr. Johnson's concern regarding the potential migration of Schedule 101 customers to Schedule 111 is misplaced. (*See* Johnson Direct, at p.17) As explained in the

Joint Rebuttal Testimony, while the Company was initially reluctant to eliminate Schedule 111 from the Mechanism until it researched the effect of migration between schedules, it has now determined that "migration occurs fairly uniformly between the schedules" with a similar number of customers migrating to and from Schedules 101 and 111. (JRT, p.9, ll.3-7) In any event, to the extent that this becomes a problem in the future, this will be part of the overall review and evaluation of the pilot program.[14]

G. Explanation of the "Roll-Over" of Deferrals from One Year to the Next.

39 Mr. Johnson next contends that if lost margins for "year two" are only half of the rolled-over excess earnings from "year one," the Company will recover all of the "year two" lost margins plus additional amounts up to the total excess earnings rolled over from "year one." (*See* Johnson Testimony at p.17, ll.7-10) This ignores the fact that, in "year two," the Company can only recover the greater of 1) the total amount of deferral that would be recorded in "year two," or 2) the amount of excess earnings carried over from "year one." It cannot recover both, as explained in the Joint Rebuttal Testimony, because any excess earnings that are rolled over from "year one" will be used to offset deferrals that would be recorded in "year two." (*See* JRT at p.11, ll.17-21)[15]

H. The Effect of Weather Normalization.

40 Mr. Eberdt, in his testimony at page 3, suggests that the Mechanism would include reduced consumption caused by, among other things, "prices or weather." It should be

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[14] Mr. Johnson also erroneously contends that the decoupling proposal recovers amounts that exceed the full lost margins for all of Schedule 101 and Schedule 111. (*See* Johnson Testimony at p.11, ll.18-20) He is comparing "apples to oranges," by comparing lost margin related to customer conservation under the DSM tariff compared with the lost margin resulting from all customer conservation. (*See* Joint Rebuttal Testimony, p.9, ll.13-16)

[15] The Mechanism contains the deferral balance "carry over" provision related to the earnings test, in order to allow the Company to avoid writing off a deferral balance that it cannot recover during the current year as a result of the test. (*See* Joint Rebuttal Testimony at p.12, ll.13-16)

clarified, yet again, that the Mechanism is designed to exclude the effects of abnormal weather. Accordingly, the Company remains "at risk" for lost margin due to weather variations, as explained in the Joint Rebuttal Testimony. (*See* p.4, ll.5-7) Moreover, the weather normalization methodology used to calculate deferrals is the same as used for the 2004 test year in the Company's most recent General Rate Case. (*See* WUTC v. Avista Corp., Docket Nos. UE-050482 and UG-050483). The use of 2004 weather normalized usage as the "base year" for determining customer usage, results in a methodology that provides for an "apples-to-apples" comparison of current customers' usage to the prior test year usage. (*See* JRT, p.13, ll.2-6)

I. Public Counsel's Proposed Alternative to the Mechanism Falls Far Short of the Objective of Encouraging Conservation.

41 Public Counsel, through Mr. Johnson at pages 18-23 of his Direct Testimony, proposes a conservation incentive/penalty mechanism as an alternative to Avista's decoupling proposal. As explained in the Joint Rebuttal Testimony, Public Counsel's alternative mechanism:

> Does nothing to address the underlying conflict we have in traditional regulation in which fixed costs are recovered through volumetric pricing, which results in a disincentive for the utility to provide an ongoing comprehensive conservation message to its customers. The decoupling mechanism better aligns the need for a constant comprehensive conservation message with ratemaking by severing the link between the recovery of fixed costs and the volume of sales.

(JRT at p.13, ll.12-19) Furthermore, Public Counsel's proposed maximum incentive level is only $138,000, and this assumes the Company can exceed its DSM program target by 30 percent. The Joint Rebuttal Testimony properly characterizes this incentive level as "not meaningful." (*See* JRT at p.13, l.20 – p.14, l.1) So, in that sense, it actually serves as a "disincentive" to engage in or encourage customers to engage in additional cost-effective

conservation, because any margin the Company would lose from the conservation program would far exceed the amount of any incentive actually available to the Company. (*Id.* at p.14, ll.1-8)[16] Simply put, the Public Counsel's alternative proposal "is a small band-aid that completely ignores the underlying disease." (*See* JRT at p.14, ll.7-8)

VI. CONCLUSION

42 The Commission should approve the Company's proposed Decoupling Mechanism, as set forth in the Settlement Agreement. This would remove the disincentive that presently exists to further encourage customer conservation of natural gas. Because it provides the opportunity for the Company to recover lost margin from all conservation efforts, including DSM programatic savings, the Settlement would better align the interests of both the Company and its customers in fully supporting conservation.

43 As explained in the Joint Direct Testimony, considerable effort has gone into the design of this pilot program. This effort included multiple workshops and various programatic revisions to reflect comments received. This has resulted in a Mechanism which, as Mr. Eberdt himself acknowledges, is the "clearest, cleanest proposal to be put forth." (*See* Eberdt Direct, at p.2)[17] If this Commission wants to better understand the actual workings of a Decoupling Mechanism in practice, it has before it a ready candidate in the form of Avista's proposed Mechanism. This three-year pilot program, which can only be renewed if justified by the Company, contains a number of "checks and balances" that

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[16] Furthermore, because conservation savings by their nature would continue for several years, the annual incentive would only compensate the Company for a mere fraction of what it has been authorized to collect in rates. (*See* JRT, p.14, ll.3-8)

[17] Mr. Eberdt also acknowledged that Avista has been "very responsive during the course of this case" and that their "conservation department is very capable and creative." (Eberdt Direct at p.7)

will assure that the Mechanism operates as intended. These are conveniently summarized in the Joint Rebuttal Testimony:

> Included among these "checks and balances" are: (1) an "earnings test"; (2) a "DSM test"; (3) a "2% cap" on annual rate adjustments; (4) an evaluation plan to be agreed upon; (5) quarterly reports on the status of deferrals under the Mechanism; (6) an independent review of DSM savings; and (7) the automatic termination of the Mechanism at the end of the pilot period unless the Company justifies, and the Commission approves, its continuance.

(JRT at p.1, ll.14-22) And, for purposes of establishing the near-term DSM goal for 2006 and 2007, the Company has established "an aggressive, unbiased target" as acknowledged in the Joint Rebuttal Testimony. (*Id.* at p.2, ll.1-2)

44 The Commission has previously noted that any decoupling Mechanism must "be designed to fit with the utility's particular circumstances." (*Rulemaking to Review Natural Gas Decoupling*, "Summary, Analysis of Comments and Decision to Close Docket Without Action," at p.10 (Docket No. UG-050369) (October 17, 2005).) The Settling Parties have worked, in earnest, to arrive at a decoupling proposal that truly fits Avista's "particular circumstances" and one that will best serve to remove the lost margin barrier to promoting additional conservation.

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45 RESPECTFULLY SUBMITTED this 14th day of December, 2006.

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