

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12 _____

DOCKET NO. UG-12 _____

DIRECT TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

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I. INTRODUCTION

Q. Please state your name, employer and business address.

A. My name is Kelly O. Norwood and I am employed as the Vice President of State and Federal Regulation for Avista Utilities (Company or Avista), at 1411 East Mission Avenue, Spokane, Washington.

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

A. Yes. I am a graduate of Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. I joined the Company in June of 1981. Over the past 30 years, I have spent approximately 19 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 & Federal Regulation in March 2002.

Q. Please summarize your testimony in this proceeding?

A. In my testimony I will show that utility operating expenses and capital investment (rate base) are growing at a much faster pace than retail sales revenues, and explain how the ratemaking practices we are currently using in Washington are not designed to provide timely recovery of costs, along with a fair return on investment, under these

1 circumstances.¹ I will also present some of the specific indicators and objective measures
 2 that show us the nature and extent of the revenue shortfall.

3 Avista is experiencing what some would refer to as an “attrition” problem. Dr. Mark
 4 Lowry, President of Pacific Economics Group (PEG), a later witness on behalf of Avista,
 5 presents an attrition study, which provides much more detail regarding the changes in
 6 Avista’s utility costs and revenues over time, as well as the extent of the revenue shortfall.

7 Finally, I will summarize the Attrition Adjustment proposed by Avista in this
 8 proceeding to address the revenue shortfall problem.

9 A table of contents for my testimony is as follows:

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19 **Q. Are you sponsoring any exhibits in this proceeding?**

20 A. Yes. I am sponsoring four exhibits. The Exhibits identified below were
 21 prepared under my direction.

22 Exhibit No. ____ (KON-2) - Standard & Poor’s, Utility Regulatory Assessments
 23 Report

¹ When I refer to retail rates that are “not designed to provide timely recovery of costs, along with a fair return on investment,” or use terms such as “revenue shortfall,” I am referring to a condition where the retail rates established for Avista result in revenues that are insufficient to provide both, 1) recovery of prudently incurred utility expenses, and 2) a reasonable opportunity for shareholders to earn a fair return on investment. A “revenue shortfall” can be caused by one or more of a combination of 1) actual retail revenue, following the period new rates are set, being less than the retail revenue included in establishing the retail rates; 2) actual utility expenses, following the period new rates are set, being more than the utility expenses included in establishing the retail rates; 3) actual utility rate base, following the period new rates are set, being more than the rate base included in establishing the retail rates; or 4) growth in revenues, utility expenses, and rate base, following the period new rates are set, being different than that expected at the time new retail rates are set.

- 1 Exhibit No. ____ (KON-3) - Regulatory Research Associates, Regulatory Focus
- 2 Report
- 3 Exhibit No. ____ (KON-4) - Actual and Authorized Rate Base Graphs by State
- 4 Exhibit No. ____ (KON-5) - NARUC, Rate Case and Audit Manual

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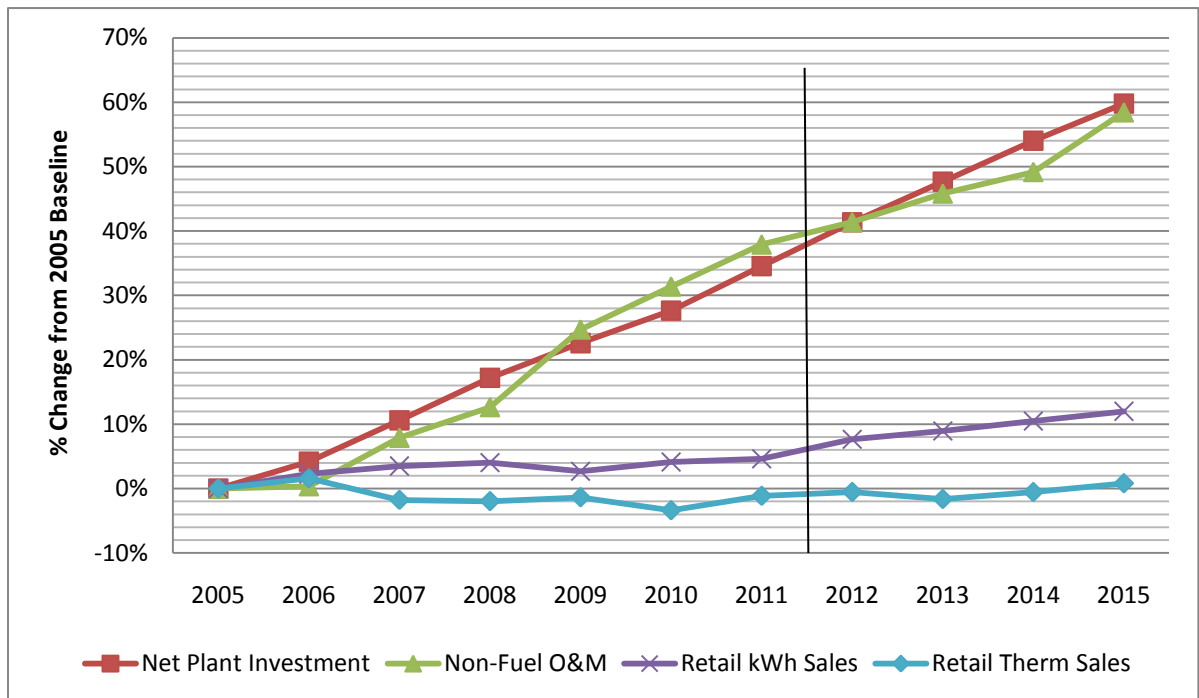
6 **II. SALES, OPERATING EXPENSES AND CAPITAL INVESTMENT**

7 **Q. Please explain the changes in sales, operating expenses and capital**
 8 **investment that the Company is experiencing.**

9 A. In Mr. Morris’ testimony, he presented the graph reproduced in Illustration
 10 No. 1 below that shows the actual changes in net plant investment, non-fuel operation and
 11 maintenance (O&M) expenses, and sales for Avista for the period 2005 through 2011. The
 12 graph also shows the expected changes for the period 2012 through 2015.

13 **Illustration No. 1**

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1 The red line on the graph shows the actual change in Avista’s net plant investment
2 from 2005 to 2011, and the forecasted change for 2012 to 2015. The green line on the graph
3 shows the change each year in non-fuel O&M expenses.

4 The purple and blue lines on the graph show the changes in total retail kilowatt-hour
5 (kWh) sales and retail therm sales, respectively, for the same time period. The graph clearly
6 shows that net plant investment and non-fuel O&M are growing at a much faster pace than
7 sales. The graph also shows this mismatch in new investment, O&M, and new sales revenue
8 is forecasted to continue into the future.

9 As I mentioned earlier, Dr. Lowry presents an attrition study, which provides much
10 more detail regarding the changes in Avista’s utility costs, net plant investment, and
11 revenues over time.

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13 **III. RATEMAKING PRACTICES IN WASHINGTON**

14 **Q. Why do the current ratemaking practices in Washington result in a**
15 **revenue shortfall under the circumstances illustrated in the graph above?**

16 A. In Washington, we use “historical test period” ratemaking to establish retail
17 rates and retail revenue. Under this type of ratemaking, we start with revenues, expenses
18 and rate base for a recent historical period, and make limited adjustments in setting new
19 retail rates for the future period. Because costs are increasing more each year than revenues,
20 and only limited pro forma adjustments are included in the general rate case process, the
21 revenues in the future period will not be sufficient to cover all the future costs, along with a
22 reasonable opportunity to earn a fair return, unless the appropriate adjustments are made to
23 the test period numbers to reflect those higher costs.

1 The following line graph illustrates the ratemaking that has been occurring in our
 2 recent rate cases. This graph is not based on specific numbers, but is for illustrative
 3 purposes, to show conceptually what has been happening in general rate cases. The graph is
 4 illustrative of a general rate case filed in 2011, using a 2010 historical test period and a 2012
 5 future rate year where new rates would be in effect.

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7 **Illustration No. 2**

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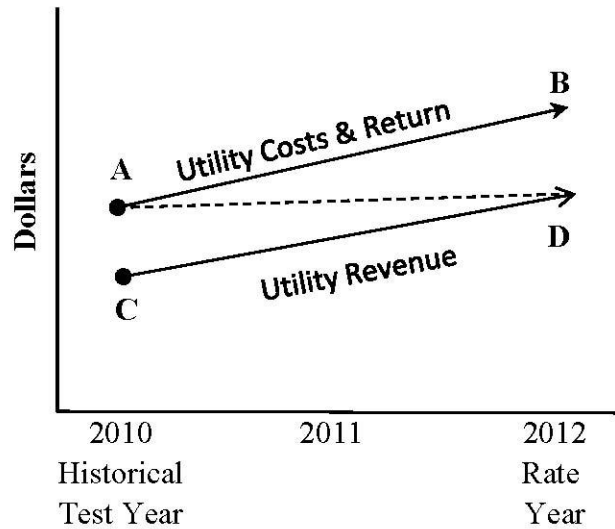
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The Utility Costs & Return line on the graph (including all O&M expenses, and the expenses and return associated with rate base) are increasing from 2010 to 2012, as illustrated, from Point A to Point B. New retail revenue for the 2012 Rate Year will be based on the normalized costs from the 2010 Historical Test Year, with limited adjustments. The dotted line from Point A to Point D illustrates the slight increase in costs included in the rate case by including some limited pro forma adjustments. And the solid line from Point C to Point D illustrates the increase in retail revenue from the Historical Test Year, to match

1 the adjusted historical test period costs, which is also reflected as Point D. The revenue
2 shortfall shown in 2010 (Points A vs C) is perpetuated as we move through time (Points B
3 vs D).

4 Illustration No. 2 is also helpful in addressing the “matching principle” that has been
5 discussed extensively in recent general rate cases. The essence of the matching principle is
6 that utility revenues, expenses and rate base should be appropriately matched for ratemaking
7 purposes for the particular period. Historically, utility rate cases have generally been
8 approached with the presumption that, for the historical test year, revenues, expenses and
9 rate base are properly matched. And as pro forma adjustments are made to the test year
10 numbers in the general rate case, an effort is made to preserve the “matching” that is present
11 in the historical test year.

12 Part of the problem we are experiencing with the retail rates that are set in a general
13 rate case, is that this presumption about the historical test year is incorrect. The graph above
14 illustrates that during the 2010 test period Avista was already experiencing a revenue
15 shortfall. Point A, which represents the costs, and return, to serve customers in 2010, is
16 higher than Point C, which represents the total retail revenue collected from customers. The
17 relationship between revenues, expenses and rate base for the historical test year should be
18 preserved going forward, only if a proper matching is present in the first place.

19 Even though the graph in Illustration No. 2 above reflects a revenue increase from
20 the general rate case, from Point C to Point D, there is still a revenue shortfall for the
21 Company in 2012, even after the rate increase. And that is precisely what Avista has been
22 experiencing in recent years. We will see this shortfall in the recent return on equity results
23 that will be presented in the next few pages of my testimony.

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

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IV. SHORTFALL

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

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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.

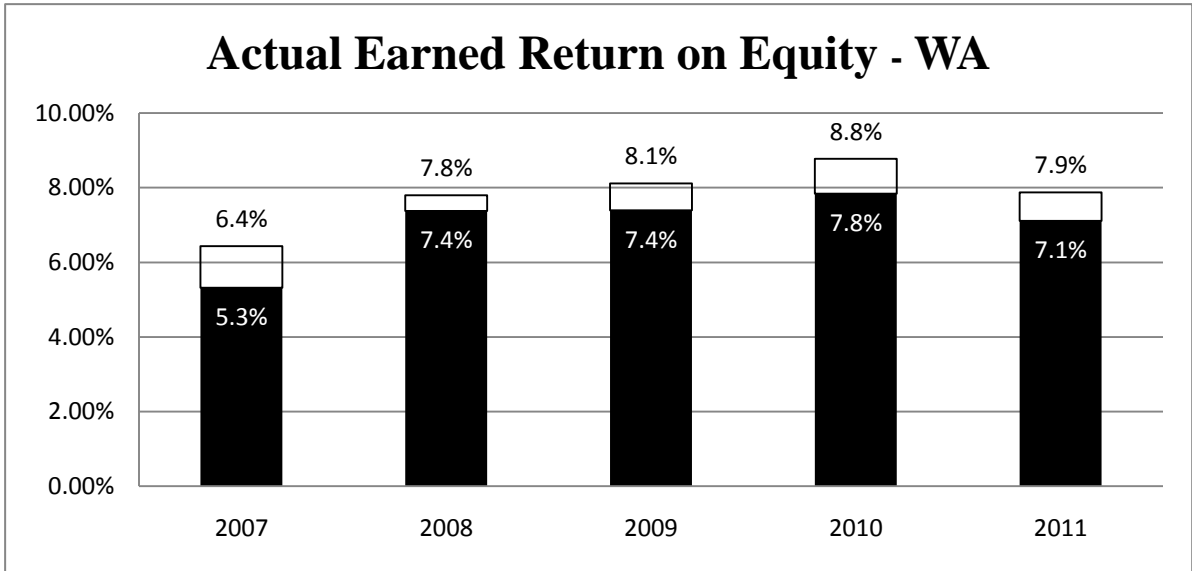
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1 Illustration No. 3



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

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

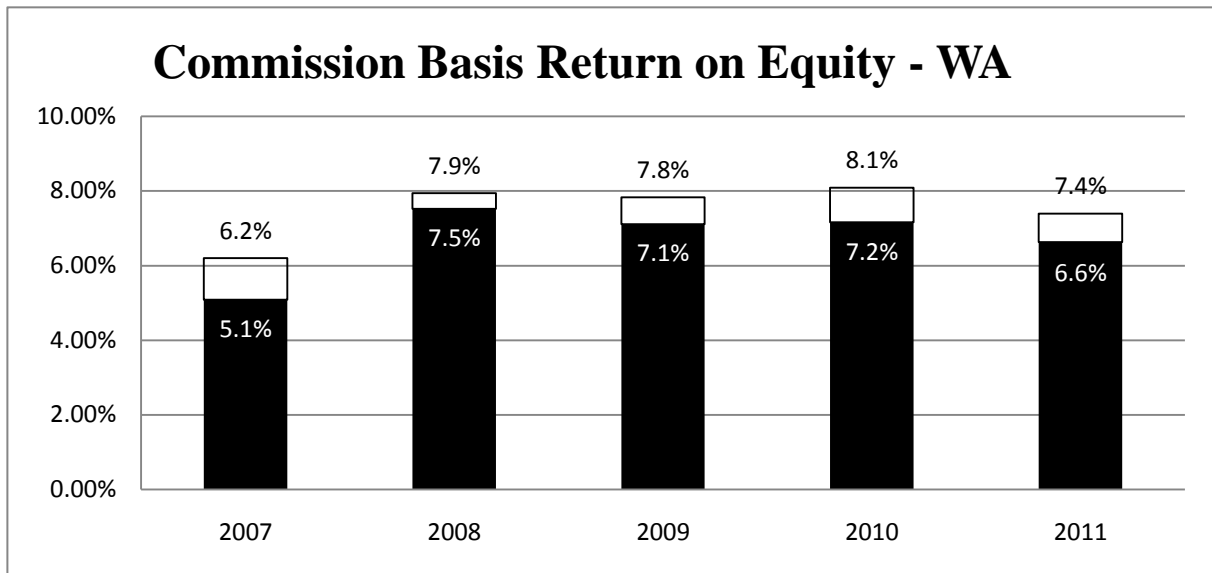
18 **Q. If you were to normalize the operating results for each of these years,**
 19 **how would that change the earned returns?**

20 A. Each year, on or before April 30th, Avista is required to file with the
 21 Commission what are referred to as Commission Basis Reports. In developing the reports,
 22 Avista normalizes the operating results for the prior calendar year to determine what its rate
 23 of return would have been if the Company had experienced normal operating conditions,

1 including, among other things, normal temperatures, normal hydroelectric conditions and
 2 wholesale electric prices, removal of prior period adjustments, etc.²

3 The bar chart in Illustration No. 4 below shows Avista’s earned return on equity
 4 (ROE) each year from 2007 to 2011 for our combined electric and natural gas operations in
 5 the State of Washington, under normalized operating conditions. The ROEs range from
 6 6.2% to 8.1%, and, as with the actual ROEs, all are well below ROEs that would be
 7 considered reasonable. The black bars, again, represent the utility ROEs including the
 8 below-the-line expenses, and the total ROEs represents the ROE excluding these expenses.

9 **Illustration No. 4**



19 The expectation under the regulatory compact³ is that, over time, there will be a
 20 reasonable opportunity, but not a guarantee, to actually earn the return on equity authorized

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 Direct Testimony of Kelly O. Norwood

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

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

7 A. The Commission Basis (normalized) ROEs from Illustration No. 4 above
 8 range from 6.2% to 8.1%. One way to measure the shortfall would be to compare these
 9 ROEs to the most recent ROEs authorized by the Commission, which would range from
 10 9.8% to 10.2%. A conservative (minimum) estimate of the shortfall is approximately 200
 11 basis points of ROE. The annual revenue shortfall of 200 basis points of ROE for Avista's
 12 Washington utility operations is approximately \$21 million.⁴

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

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

lack of competition is offset with regulation. As Dr. Bill Avera states in his testimony, the U.S. Supreme Court, in the Bluefield and Hope 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 opportunity to actually earn 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.

1 category of “Less Credit Supportive.” A copy of this report is attached as Exhibit No. ____
2 (KON-2).⁵

3 In addition, Regulatory Research Associates (RRA) more recently issued a report,
4 dated January 19, 2012, of its evaluation of the regulatory climate in each state. The report,
5 at Page 1, states that “The evaluations are assigned from an investor perspective and indicate
6 the relative regulatory risk associated with the ownership of securities issued by each
7 jurisdiction’s electric and gas utilities.” Washington is rated “Average 3,” a weaker, less
8 constructive rating within the Average category. A copy of the report is attached as Exhibit
9 No. ____ (KON-3).

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VI. RETURNS IN OTHER JURISDICTIONS

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**Q. Is Avista experiencing a similar revenue shortfall in the other
13 jurisdictions in which it serves?**

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A. No. In Oregon, Avista is allowed to use a forecasted test year, which
15 provides the opportunity to better reflect in new retail rates the costs to serve customers for
16 the period that new rates are in effect. Oregon also generally supports a higher level of
17 equity in the capital structure. These factors, among others, provide the opportunity for
18 Avista to recover its costs to provide service to customers, along with a return on equity
19 more in line with the ROE authorized by the Oregon Commission.

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In the State of Idaho, although we begin with a historical test period, pro forma
21 adjustments are made to more closely reflect the costs, and return, associated with providing

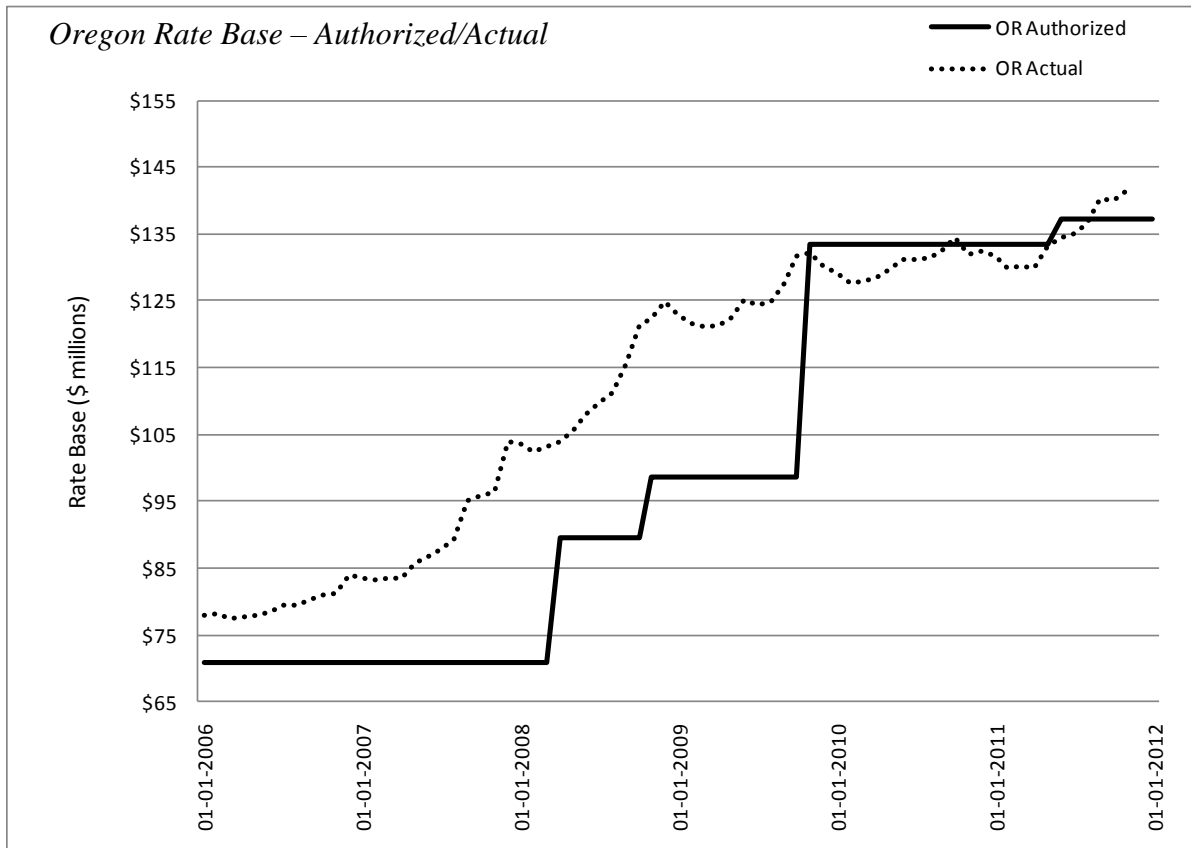
⁵ In a recent telephone conversation with a representative of S&P, they indicated that a new updated report would likely be issued this year.

1 service to customers for the future rate year. As with Oregon, Idaho also generally supports
 2 a higher level of equity in the capital structure.

3 **Q. Are there other specific examples you can provide that illustrate the**
 4 **differences in ratemaking?**

5 A. Yes. The solid line on the graph in Illustration No. 5 below shows actual rate
 6 base for Avista’s retail service in the State of Oregon each month for the period January
 7 2006 to January 2012. The dotted line on the graph shows the amount of rate base included
 8 in retail rates. The conclusion from the graph is that, for the last couple of years, the amount
 9 of rate base included in retail rates is approximately equal to the actual amount of rate base
 10 that Avista has in place serving customers.

11 **Illustration No. 5**

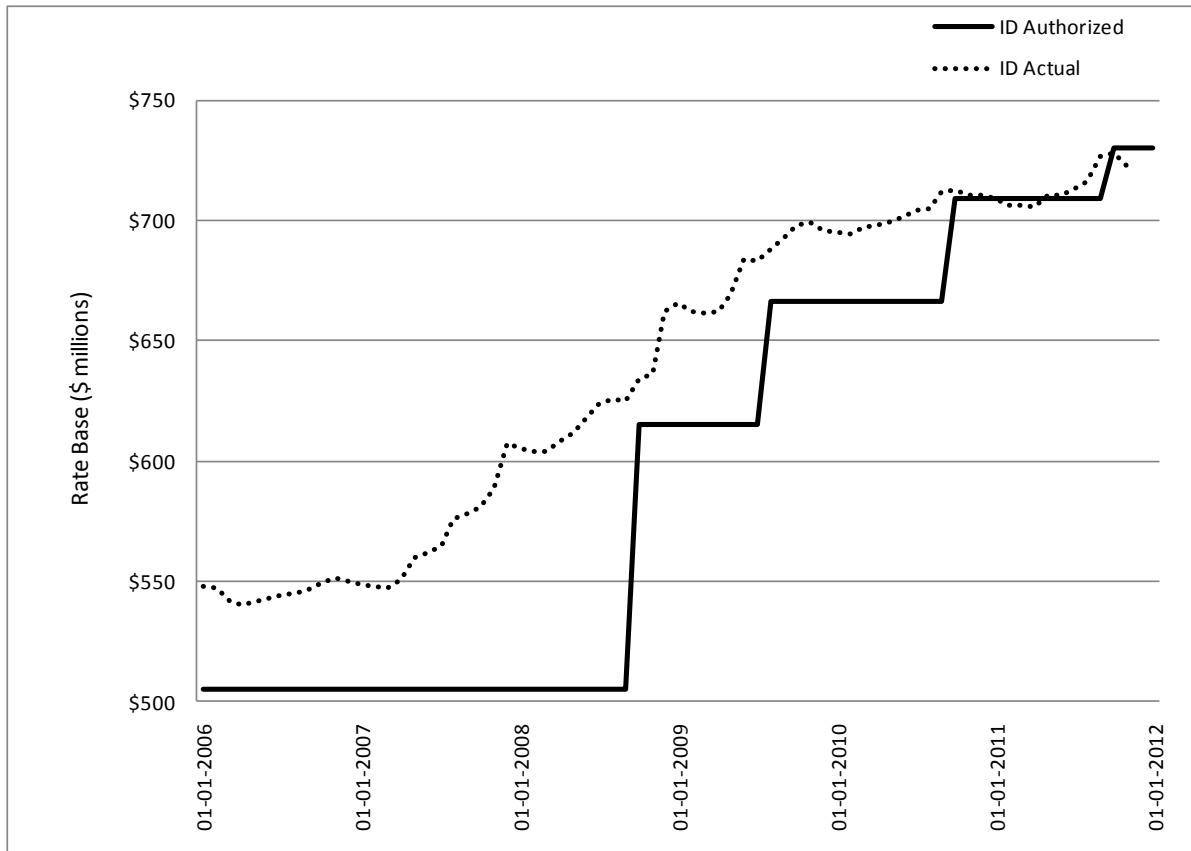


1 A similar result for the State of Idaho is shown in Illustration No. 6 below. The solid
 2 line on the graph shows actual rate base for Avista’s retail service in the State of Idaho each
 3 month for the period January 2006 to January 2012. The dotted line on the graph shows the
 4 amount of rate base included in retail rates. Again, the conclusion from the graph is that the
 5 amount of rate base included in retail rates is currently approximately equal to the actual
 6 amount of rate base that Avista has in place serving customers.

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Illustration No. 6

9 *Idaho Rate Base – Authorized/Actual*

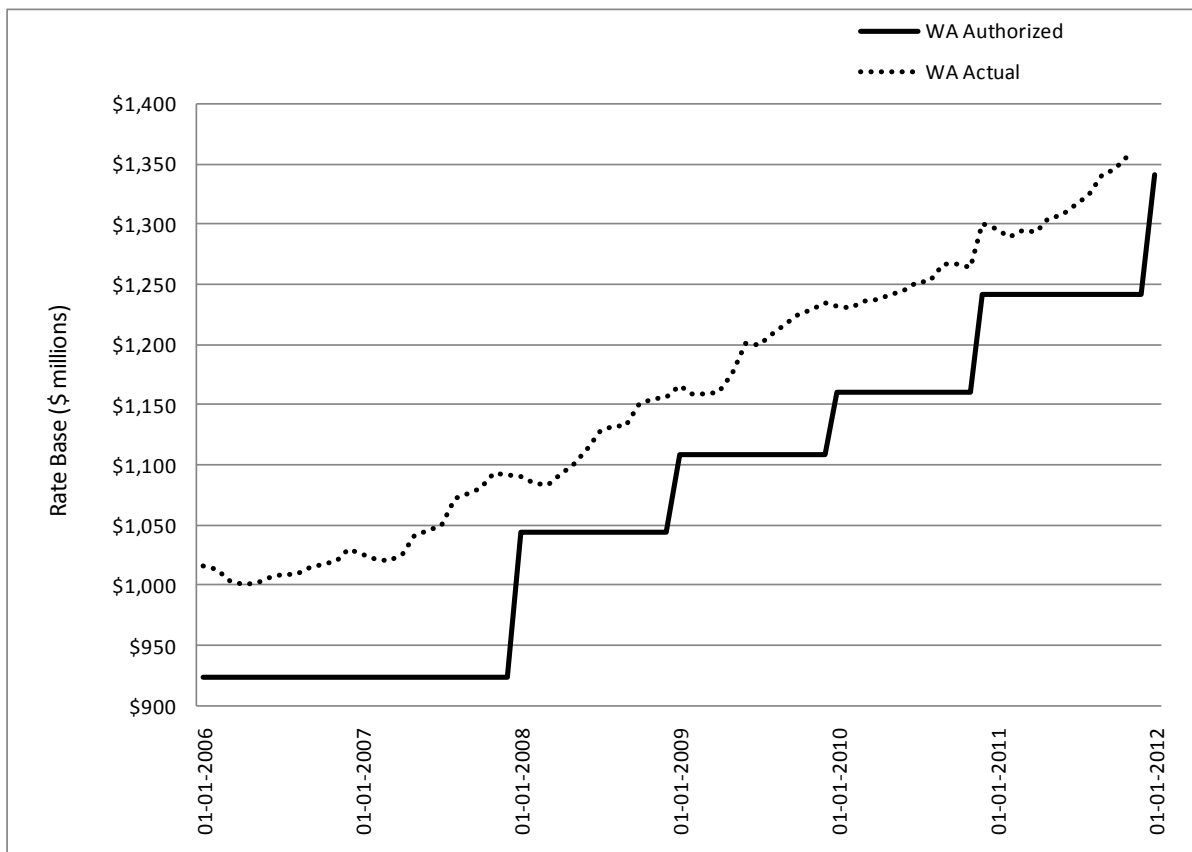


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 22 The same graph for Avista’s service in the State of Washington is shown in
 23 Illustration No. 7 below. As with the other two states, the solid line on the graph shows
 24 actual rate base for Avista’s retail service in the State of Washington each month for the

1 period January 2006 to January 2012. The dotted line on the graph shows the amount of rate
 2 base included in retail rates. The graph shows that the amount of rate base included in retail
 3 rates is consistently less than the actual amount of rate base that Avista has in place serving
 4 customers, and this is part of the chronic revenue shortfall that Avista is experiencing.
 5 Although the apparent difference between the two lines on the graph does not look that
 6 great, the order of magnitude is on average \$80 to \$90 million of rate base, which translates
 7 into roughly \$10 to \$12 million of revenue shortfall every year. This shortfall is significant.

8 **Illustration No. 7**

9 *Washington Rate Base – Authorized/Actual*



1 The three graphs in Illustrations Nos. 5 through 7 are also provided in Exhibit No.
2 ____ (KON-4).

3 **VII. COMMISSION AUTHORITY**

4 **Q. Do the laws in the State of Washington or the Commission’s rules need**
5 **to be changed to allow appropriate adjustments to be made to address this chronic**
6 **revenue shortfall?**

7 A. No. We believe the Commission has the authority under existing state law
8 and its own rules to approve appropriate ratemaking adjustments to provide Avista with the
9 opportunity to recover its costs, along with a fair return for shareholders.

10 Guidance related to appropriate pro forma adjustments to accomplish this purpose
11 includes, but is not limited to, the following:

12 WAC 480-07-510(3)(e)(iii), ‘Pro forma Adjustments’ give effect for the test period
13 to all known and measurable changes that are not offset by other factors.” (emphasis
14 added)

15 In the WUTC’s 6th Supplemental Order in Docket No UW-010877, dated July 12,
16 2002, the Commission stated, at Paragraph 29, with regard to adjustments to the historical
17 test year, that adjustments will be made:

18 for known and measurable events that will occur prospectively (pro forma
19 adjustments), to best estimate the relationship between the Company’s costs and
20 revenues and thus establish rates that are fair, just, and reasonable and allow the
21 Company the opportunity to earn a fair rate of return. (emphasis added)

22 It has been common practice for pro forma adjustments to be approved by the
23 Commission based on reasonable estimates for the rate year. As an example, in Docket No.
24 UE-090134 Commission Staff explained its recommended approval of Avista’s pro forma
25 adjustment related to the Noxon Unit No. 3 hydroelectric project upgrade as follows:

1 “[T]he Commission has allowed inclusion in rate base of plant that will be used and
 2 useful during the rate year. There must be a reasonable expectation that the plant will
 3 be complete and the costs are prudent.” (emphasis added) (Kermode Revised
 4 Exhibit (DPK-1T), at page 40).

5 In fact, if “reasonable estimates” are not allowed in ratemaking for the prospective
 6 rate year, it would be impossible for the Company to have the opportunity to recover its
 7 costs of providing service to customers during the period that retail rates will be in effect,
 8 together with a reasonable opportunity to earn a fair rate of return.

9 The UTC Staff has previously made reference to the Rate Case and Audit Manual
 10 (NARUC Manual), prepared by the NARUC Staff Subcommittee on Accounting and
 11 Finance (Summer 2003), which provides one source of guidance in processing a general rate
 12 case filed by a utility. The following excerpts from the Introduction section (Page 4) of the
 13 NARUC Manual provide instruction as to the purpose of the manual:

14 This manual has been prepared by the National Association of Regulatory Utility
 15 Commissioners (NARUC) Staff Subcommittee on Accounting and Finance as a
 16 guideline for state, territory, and federal regulatory utility commission personnel.⁶ It
 17 is not our intent to provide a checklist for use by commission auditors, accountants
 18 or analysts.⁷ Rather, it is our intent to set forth the most common, basic regulatory
 19 principles, processes, and procedures used by many regulatory commissions to
 20 examine and investigate general rate applications. We anticipate that each regulatory
 21 jurisdiction will have areas of uniqueness and specific areas of differences when it
 22 comes to examining a utility’s revenue requirement and operating earnings.
 23 Recognizing that these differences exist, we have tried to present the basic steps of
 24 the rate case investigation in such a way that revisions and changes can be made by
 25 the individual jurisdictions while maintaining the overall usefulness of the more
 26 general guidelines. (emphasis added)

27 An example of a common difference among the jurisdictions is the test year used.
 28 Some states use an average historic test year, others use a year-end historic test year,
 29 and others use projected, future test periods. Yet, this difference does not generally
 30 change the nature or importance of the test year, nor does it change the basic list of
 31 elements that are included in the rate base or the operating income statement.

⁶ The term “Commission” used throughout this document refers to the individual state, territory, or federal regulatory commission that is examining and investigating the general rate application.

⁷ The term “auditor” used throughout this document refers collectively to auditors, accountants, and analysts.
 Direct Testimony of Kelly O. Norwood

1 A copy of this NARUC Manual is attached at Exhibit No. ____ (KON-5).

2 Some of the principles in the NARUC Manual directly address the revenue shortfall
3 problem Avista is experiencing, and, in fact, support the use of appropriate adjustments to
4 ensure that the new retail revenues resulting from a general rate case will provide recovery
5 of utility costs, along with a reasonable opportunity to earn a fair return. Some of these
6 important principles are included in the following excerpts from the NARUC Manual:

- 7 1. Whether using a future or historic test year, the auditor should judge the
8 appropriateness of the test year that has been proposed. Is it representative, after
9 adjustments, of the period in which rates take effect? (Page 10) (emphasis added)
- 10 2. When looking at an historic test year, one of the first questions asked is whether the
11 test year is too stale to make it a reasonable basis upon which to establish rates for a
12 future period. In looking at the appropriateness of the test year (and whether it might
13 be too old), one should look at what has happened since the end of the test year and
14 the current time. (Page 10) (emphasis added)
- 15 3. In looking at the months beyond the end of the test year, have the growth rates for
16 rate base, expenses, and revenues all remained fairly close and constant, maintaining
17 the test year relationship among these three elements, or has one element changed
18 dramatically, making the test year out of kilter with current operations? If so, can this
19 situation be resolved through adjustments to the test year? (Page 10) (emphasis
20 added)
- 21 4. A utility's rate filing commonly begins with test year booked numbers, which are
22 then adjusted to represent anticipated, normalized operations for the period, that the
23 rates will take effect. (See Revenue Requirement Computation example toward the
24 end of this document.) Several types of adjustments may be included, and these
25 adjustments may be referenced by different names in different jurisdictions.
26 Commonly, these adjustments will include correcting adjustments (e.g., the removal
27 of prior period items from the test year), normalizing adjustments (e.g., adjusting
28 revenues for normalized weather conditions or for a normalized level of expenses),
29 and pro forma adjustments (e.g., the reflection of authorized salary increases into the
30 test year figures). In general, the pro forma adjustments can be viewed as a
31 ratemaking attempt to transform the relationship that exists between the elements of
32 cost of service (revenues, expenses, taxes, and investment) during the test year to one
33 that would take place during the period that the rates resulting from the rate
34 proceeding take effect. One is trying to identify circumstances during the test year, or
35 beyond the end of the test year, that impact the on-going expenditures or revenues of
36 the utility. (Page 15) (emphasis added)

1 5. In reviewing the prudence and reasonableness of the adjustments proposed by the
2 utility, the auditor should ultimately keep in mind that the ultimate purpose of the
3 review is to determine a revenue requirement and customer rates that are just, fair,
4 reasonable, and sufficient. (Page 15) (emphasis added)

5 6. The auditor should not only review the utility's proposed adjustments, but should
6 also look for the adjustments that have *not* been made. Are there adjustments missing
7 that if made would make the test year more reflective of normal, on-going
8 operations? (Page 15) (emphasis added)

9 7. While the proper matching of booked investment, expenses, and revenue would
10 argue in favor of an average test year, many jurisdictions have moved toward the use
11 of year-end balances. One rationale for using year-end balances is to offset
12 regulatory lag, and to make the plant more reflective of the time that rates are to be
13 placed into effect. (Page 16) (emphasis added)

14 8. Additionally, one will want to look at a multi-year comparison of annual revenue to
15 obtain a view of the trend for the utility. Is it growing and if so, is the growth
16 relatively consistent? Is the growth related to new customers or additional usage of
17 existing customers? (The answer to this question may help explain whether the
18 growth in revenue is consistent or inconsistent with growth in plant.) Are revenues
19 and expenses growing together? (Page 31) (emphasis added)

20 9. One of the overriding principles to remember when reviewing expense related
21 adjustments is the concept of *known and measurable*, particularly when dealing with
22 adjustments to historic test periods. It is widely accepted that adjustments should
23 have a strong degree of certainty associated with them, and that there should be a
24 reasonable ability to measure the item underlying the adjustment. (Page 35)
25 (emphasis added)

26 The pro forma adjustments that would be necessary in a general rate case to address
27 the revenue shortfall problem, are fully consistent with Washington State Law, the
28 Commission's rules, and the principles laid out above from the NARUC Rate Case and
29 Audit Manual.

VIII. PROPOSALS TO ADDRESS SHORTFALL

1
2 **Q. Has the Company provided specific proposals in this filing to address the**
3 **persistent revenue shortfall that is occurring every year?**

4 A. Yes. Company witness Ms. Andrews summarizes each of the restating and
5 pro forma rate case adjustments to the historical test period that have, from time to time,
6 been adopted in prior rate cases. However, as we have seen in the actual earned ROEs and
7 the Commission Basis ROEs for prior periods, these pro forma adjustments in prior cases
8 have not provided sufficient revenue.

9 To address this shortfall, the Company retained Dr. Mark Lowry, President of Pacific
10 Economics Group (PEG) Research, LLC., to prepare an Attrition Study to determine
11 whether the Company will experience continued erosion in its earnings through the 2013
12 rate year. The testimony of Dr. Lowry (Exh. No. ____MNL-IT) addresses the chronic
13 underearning that the Company faces by virtue of the continued application of past
14 regulatory approaches. He notes that utilities today face operating conditions that differ
15 from the past, in that cost growth is much more likely to outpace growth in billing
16 determinants. (Id. at p. 8, ll.15-20) Mr. Lowry observes that:

17 The problem is aggravated to the extent a utility must contend with either high capex
18 requirements or unusually sluggish or negative growth in average use. Utilities that
19 must contend with these challenges under traditional regulation are likely to file
20 annual rate cases and receive rate adjustments that are uncompensatory. (Id.)

21 **Q. What method did Dr. Lowry use to arrive at an Attrition Adjustment?**

22 A. Dr. Lowry attempted, where possible, to conform to past practices accepted
23 by this Commission in developing an attrition adjustment. He relied primarily on Avista's
24 historical trends in arriving at his attrition calculation, and made use of Commission Basis

1 Reports (CBR's) for several prior years that include normalized cost and revenue data for
2 Avista's Washington electric operations. As such, his analysis of historical cost trends relies
3 on normalizing methods that have been approved by this Commission and reflected in the
4 CBR's.

5 **Q. Would you be more specific?**

6 A. Yes. As noted, Dr. Lowry used prior Commission Basis Reports to develop
7 trends in revenues, expenses, and rate base. He then applied the trends to amounts contained
8 in the 2011 Commission Basis Report to develop trended values out to the rate effective
9 period of calendar year 2013. In the case of power supply-related revenues and expenses,
10 Dr. Lowry used the amounts developed by the Company, as discussed and presented by
11 Company witness Mr. Johnson. In the case of retail revenue, Dr. Lowry used the
12 Company's forecast of loads for 2013 with revenue associated with load growth being
13 determined using a weighted billing determinant index. Since the rate increase in this
14 proceeding will be applied to the 2011 test period billing determinants, Dr. Lowry divided
15 his rate year, attrition-adjusted revenue requirement by the revenue growth factor to reduce
16 the revenue requirement to be applied to the test period level of retail loads. The result of
17 Dr. Lowry's analysis is an overall revenue requirement of \$41.502 million, including the
18 impact of attrition.

19 **Q. What did Dr. Lowry conclude?**

20 A. His analysis demonstrates that Avista's costs will grow much more rapidly
21 than its billing determinants between 2011 and 2013, resulting in continued underearning,
22 absent an Attrition Adjustment. As such, he proposes an Attrition Adjustment of
23 approximately \$20.5 million, which is reflected in the proposed revenue requirement of the

1 Company.⁸ Stated differently, he estimates a revenue deficit of about \$20.5 million in 2013,
2 the first year new rates are in effect, if the revenue increases were to be limited only to the
3 pro forma adjustments proposed by the Company. (Id. at p. 3, ll 3-10). The revenue
4 adjustment associated with his Attrition Adjustment is shown in Company witness Ms.
5 Andrew's Exh. No. ____ (EMA-2) at page 9, columns AA-Ttl, line 49.

6 **Q. Were the Commission to simply adopt a year-end rate base for 2011, as**
7 **requested by the Company, without doing more by way of an Attrition Adjustment,**
8 **would this solve the Company's revenue shortfall problem?**

9 A. No, it wouldn't. The difference in electric revenue requirement between an
10 AMA verses year-end rate base for 2011 is \$5.363 million (which includes the effect of
11 depreciation). (See Exh. No. ____ (EMA-2), p.8, col. (3.07), line 50). The Attrition
12 Adjustment developed by Dr. Lowry for the period of 2012-2013, represents an additional
13 \$20.5 million of necessary rate relief. Therefore, simply adopting year-end rate base,
14 without more, will not solve the Company's earnings attrition.

15 **Q. As a "cross-check" on the reasonableness of Dr. Lowry's Attrition**
16 **Adjustment showing a \$20.5 million shortfall in 2013, did Ms. Andrews also analyze**
17 **the effect of growth in rate base and the impact of DSM through 2013?**

18 A. Yes, she did. Ms. Andrews started with the unadjusted results of operations
19 for 2011 and prepared specific restating and pro forma adjustments that have, at various
20 times, been adopted in prior rate cases. As such, she pro formed plant investment through
21 the end of the 2011 historical test period (year-end test period rate base). She presented an

⁸ He derives an overall revenue requirement (including attrition) during the 2013 rate year of \$41.502 million (Exh. ____ MNL-5, p. 2, l. 56), from which the Company subtracted \$20.988 (representing pro forma adjustments sponsored by Ms. Andrews in Exh. ____ EMA-2, p. 9, l. 50), in order to isolate the attrition portion of his adjustment (\$20.5 million).

1 analysis of what the revenue requirement would have been if the costs associated with rate
2 base for the 2013 calendar year were included. They include incremental additions to rate
3 base to reflect: 1) 2012 Year-End Rate Base, and 2) 2013 AMA Rate Base. Company
4 witness Mr. DeFelice provides additional testimony related to these components.

5 Next, Ms. Andrews captured in her analysis the impact of the ongoing DSM
6 program. In a general rate case, we begin with historical test period KWH sales, and then
7 erroneously assume that all of those historical retail sales, and revenues, continue into the
8 future rate year, when we know with certainty that part of this revenue will not occur,
9 because customers have taken steps to use less energy. Company witness Mr. Ehrbar
10 provides additional testimony related to this issue.

11 The total revenue requirement associated with the three components of Ms. Andrews'
12 analysis, including the 2012 planned capital expenditures, the 2013 planned capital
13 expenditures and the impact of DSM, is \$20.4 million. By comparison, Dr. Lowry's
14 Attrition Adjustment, used by the Company for purposes of deriving a revenue requirement,
15 is \$20.5 million. As I discuss elsewhere in my testimony, the Company has been
16 experiencing a revenue shortfall of at least 200 basis points in ROE, which is equal to
17 approximately \$21 million.

18 **Q. Would you please summarize the difference in the methodologies used by**
19 **Dr. Lowry and by Ms. Andrews?**

20 A. Yes. Dr. Lowry used a historical trend analysis to develop a total, attrition-
21 adjusted revenue requirement used by the Company. His revenue requirement includes the
22 shortfall that existed during the 2011 test period as well as the shortfall that exists between
23 the 2011 test period and the 2013 rate year. Ms. Andrews, on the other hand, used specific

1 pro forma adjustments coupled with an analysis of planned capital expenditures and DSM
2 impact through the 2013 rate year. The results of her analysis are consistent with those of
3 Dr. Lowry, even though both approached the issue in an entirely different way: Dr. Lowry
4 developed an Attrition Adjustment based on trending of historical data (as in prior attrition
5 studies accepted by this Commission), while Ms. Andrews essentially arrived at a revenue
6 shortfall based on actual, planned investments and DSM impacts through 2013. The end
7 result of the two separate, independent methodologies provides a confirmation that the
8 attrition-adjusted revenue requirement under either method is reasonable and supportable.

9 **Q. Are Ms. Andrews' or Dr. Lowry's values used in the final attrition**
10 **adjusted results and why?**

11 A. The total revenue requirement (reflecting attrition) developed by Dr. Lowry's
12 Attrition Study is used by Ms. Andrews' for the final adjusted results and revenue
13 requirement. The adjustments and values shown in Ms. Andrews' exhibit (Exh. No.
14 ____ (EMA-2), p.9) however, were used for the limited purpose of preparing the cost-of-
15 service study that is presented by Company witness Ms. Knox, because these values more
16 readily lend themselves to Ms. Knox's cost-of-service analysis. This is because
17 expenditures related to specific plant are only set forth in the necessary detail in Ms.
18 Andrews' analysis as required for purposes of assigning and allocating such expenses to
19 their appropriate functional classifications for cost-of-service purposes.

20 **Q. What is the impact that Dr. Lowry's Attrition Adjustment has on rate of**
21 **return, return on equity, and the revenue requirement?**

1 A. The Attrition Adjustment results in a 104 basis point (1.04%) reduction in
2 rate of return, which equates to a 215 basis point (2.15%) reduction in return on equity. The
3 revenue requirement associated with the Attrition Adjustment is \$20.5 million.

4 **Q. Why is approval of the attrition-adjusted revenue requirement**
5 **necessary?**

6 A. Approval of the proposed attrition-adjusted revenue requirement is necessary
7 to address the persistent revenue shortfall that Avista is experiencing each year. Unless
8 additional revenue is granted to address the attrition problem, the Company will not have an
9 opportunity to earn its authorized rate of return. A shortfall of approximately 100 basis
10 points in rate of return and approximately 200 basis points in return on equity will continue
11 to occur without an Attrition Adjustment. Avista will not be provided with a “reasonable”
12 opportunity to earn its authorized cost of capital.

13 **Q. Does this conclude your pre-filed direct testimony?**

14 A. Yes.