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SERVICE DATE

SEP 29 2000

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	DOCKET NO. UE-991606
Complainant,	)	
v.	)	DOCKET NO. UG-991607
AVISTA CORPORATION,	)	THIRD SUPPLEMENTAL ORDER
Respondent.	)	
....	)	

Synopsis: The Commission orders an overall gas rate increase of $1,672,000, or 2.1 percent.

The Commission orders an overall electric temporary rate decrease of $3,406,000, or 1.4 percent.

The Commission orders further proceedings to determine any appropriate power cost adjustments.

The Commission orders a bill credit of $19,869,296 million to reflect the ratepayers' portion of gain on sale of the Centralia coal plant facility.

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I. SUMMARY AND PROCEDURAL HISTORY

A. Summary

1 The overall results of this order produce a relatively small increase in Avista's gas rates, about $1.67 million a year, or 2.1 percent; and, pending further proceedings, a relatively small reduction in Avista's electricity rates, about $3.41 million a year, or a 1.4 percent decrease.

2 The predominant factor driving this result is the 1998 test year buydown of a contract Avista had with Portland General Electric (PGE) that transformed a series of annual $18 million payments into a lump sum cash payment of $143.4 million.

3 Following the recommendations of Commission Staff, Public Counsel and ICNU, the Commission orders Washington's share of this cash balance (approximately $100 million) to be used to: remove regulatory assets from the Company's books (including $21 million in past weatherization expenditures); recover certain expenses (Nez Perce tribal agreement and contract with Wood Power, about $5 million together); and buy down the Company's general rate base ($37 million, proportional to the value of Avista's Rathdrum generating plant). The remaining $37 million will be returned to ratepayers over 8 years.

4 In addition, ratepayers will receive their share of the proceeds from the Centralia plant sale ($19,869,296 million) in a single lump sum bill credit. This is the same treatment approved for Puget Sound Energy for *its* Centralia gain.[1]

5 Because power costs are such an important factor in this case, and because the models presented for determining them were flawed, the electricity rates are temporary, and the Commission orders Avista to file a power cost case next year to obtain more accurate power costs through an improved electricity cost model. The Commission accepts the Company's figures on several issues for purposes of setting the temporary

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[1] *In re Avista Corporation, PacifiCorp and Puget Sound Energy Petitions to Sell the Centralia Plant and Related Facilities*, Docket Nos. UE-, UE-991262 and UE-991409, Fifth Supplemental Order (August 22, 2000).

rates (including the cost of power to replace Centralia and of short-term capacity purchases).

6 The Commission does not accept Avista's proposed Power Cost Adjustment (PCA) at this time, finding that a power cost case is the appropriate forum to address how a PCA should align and balance risks faced by customers and the company.

7 The Commission approves a return on equity of 11.16 percent. Applying this to a capital structure of 42 percent equity, 45 percent long-term debt, 4 percent short-term debt, and 9 percent preferred stock, Avista's overall rate of return is set at 9.03 percent.

8 Regarding the expenses that the Company proposed to put in rates:

- The Commission does not include Icestorm and Firestorm costs in rates. These extraordinary expenses took place outside the test year.

- The Company's Year 2000 (Y2K) costs are allowed as a reasonable part of the Company's duty to provide service and be prepared.

- Changing the company name to Avista was not clearly for the benefit of ratepayers, so expenses associated with that should not be assigned to them.

- Costs associated with the search for a Chief Executive Officer (CEO) should be allocated in part to subsidiary firms.

- Officer salaries should also be allocated using the same split between the regulated utility and the unregulated subsidiaries.

- Signing bonuses for officers should not be included in rates, but compensation in the form of some restricted stock is appropriately included.

- Total CEO compensation of $410,900 is appropriate to include in rates, with shareholders and affiliates responsible for the balance.

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- Basic monthly rates for electricity and gas should increase to $5 a month, moving basic rates toward the recovery of the fixed costs of providing service.

B. Parties

9 The parties were present as follows: Avista Corporation ("Avista") by David Meyer, General Counsel; the Washington Utilities & Transportation Commission and its staff ("Commission Staff") by Gregory J. Trautman, Assistant Attorney General and Mary M. Tennyson, Senior Assistant Attorney General, Olympia; Public Counsel by Simon ffitch, Assistant Attorney General, Seattle; Industrial Customers of Northwest Utilities ("ICNU") by S. Bradley Van Cleve and Melinda J. Davison, Davison Van Cleve, P.C.; Northwest Industrial Gas Users ("NWIGU") by Edward A. Finklea, Energy Advocates LLP, Portland; Northwest Energy Coalition ("NWEC") by Danielle Dixon, Policy Associate, Seattle; and Spokane Neighborhood Action Programs ("SNAP") by Don Andre, Assistant Director, Housing Improvements, Spokane.

C. Procedural History

10 On October 22, 1999, Avista Corporation ("Avista" or "the Company") filed certain tariff revisions designed to effect general increases in its rates for electric and natural gas services in Dockets No. UE-991606 and UE-991607, respectively. The Company's letter of transmittal indicates that the cumulative effect of the tariff filing would be to increase annual electricity revenues by $26.25 million and natural gas revenues by $4.9 million. The Commission, by Orders entered November 30, 1999, suspended the operation of the tariff revisions pending further hearings. The two matters were consolidated. Additional notice was given on April 28, 2000, that the Commission would consider whether existing rates are just, fair, reasonable, and sufficient, and in the public interest.

11 Commission Staff in its filing recommends that Avista should lower its electric rates by $19.9 million. *Staff Brief at 105.* million per year, and proposes a natural gas rate increase of $782,000 per year. Public Counsel recommends a rate reduction of $37.7 million *(Public Counsel Brief at 2)* for electricity and a rate reduction of $1.026 million for natural gas. ICNU recommends a rate reduction of $24.6 million *(ICNU Brief at 3)* for electric rates. After taking into account certain accepted adjustments

and revisions, the Company's revised requests seek an electric rate increase of $18.165 million and a revised natural gas rate increase of $4.427 million.

12 The Commission convened prehearing conferences in this matter in Olympia, Washington, on December 16, 1999, March 22, 2000, and July 6, 2000, before Administrative Law Judge Marjorie R. Schaer. The Commission conducted evidentiary hearings on March 26 through 31, 2000, and July 10 through 14, 2000, before Chairwoman Marilyn Showalter, Commissioner Richard Hemstad, Commissioner William R. Gillis, and Administrative Law Judge Marjorie R. Schaer. Finally, hearing proceedings were conducted on April 20, 2000, before the Commissioners and Administrative Law Judge Schaer, in Spokane, Washington, to receive into the record comments from ratepayers and other members of the public who expressed an interest in the outcome of this general rate case.

13 During the proceedings on July 13, 2000, the Commission received and considered a Stipulation entered into by Avista and the Commission Staff regarding use of an appropriate water record for normalizing hydroelectric generation. Exhibit 740 is the Stipulation. These parties proposed that the Stipulation be accepted as a fair and reasonable resolution of how hydroelectric generation would be normalized. *TR pp. 1767-1773*. Public Counsel did not oppose the Stipulation. Following presentation by the parties, and inquiry from the Bench, the Commission deliberated in chambers and determined that the Stipulation should be approved and adopted. The Commission announced that decision on the record at the proceedings on July 13, 2000 *(TR p. 1911),* and finalizes its determination through this Order in accordance with WAC 480-09-780.

II. DISCUSSION AND DECISION

A. Principles of Utility Rate Setting

14 The ultimate determination to be made by the Commission in this matter is whether the rates and charges proposed in the revised tariffs are fair, just, reasonable, and sufficient, pursuant to RCW 80.28.020. These questions are resolved by determining the Washington intrastate adjusted results of operations during the test year, establishing the fair value of the Company's property-in-service for intrastate service in the state of Washington (rate base), determining the proper rate of return permitted

the Company on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return.

15 In order to accomplish these tasks, the parties in a rate proceeding develop evidence from which the Commission may determine the following:

16 (1) The appropriate test period, which is defined here as the most recent 12-month period for which income statements and balance sheets are available. The test period is used for investigation of the Company's operations for the purposes of this proceeding;

17 (2) The Company's results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable events;

18 (3) The appropriate rate base, which is derived from the balance sheets of the test period. The rate base represents the net book value of assets provided by investors' funds which are used and useful in providing utility service to the public;

19 (4) The appropriate rate of return the Company is authorized to earn on the rate base established by the Commission;

20 (5) Any existing revenue excess or deficiency; and

21 (6) The allocation of the rate increase or decrease, if any, fairly and equitably among the Company's ratepayers.

B. Test Year and Allocation and Conversion Factors

22 All parties have used calendar year 1998 as the test period for investigation of the Company's operations for the purposes of this proceeding.

23 After the amount of operating income Avista Utilities needs in the rate year has been determined, that amount will be allocated between the Washington and Idaho jurisdictions where the Company has utility operations. The parties have agreed that

an "allocation factor" of 66.99 percent should be applied to the total to determine the Washington jurisdictional share.

24 The resulting Washington jurisdiction net operating income represents the amount of income Avista should have the opportunity to earn in this state, after it has paid its federal income taxes. The net operating income amount must be "converted" to the revenue requirement amount that Avista should have the opportunity to earn. The conversion factor calculates the pre-tax revenue needed to generate the pro forma net operating income. The parties have agreed that a conversion factor of 0.620919 should be used for electrical operations, and that a conversion factor of 0.616505 should be used for gas operations.

Commission Discussion and Decision

25 The Commission approves use of the 1998 test year, and the 66.99 percent allocation factor allocating costs between Washington and Idaho. The Commission approves use of a conversion factor of 0.620919 for electrical operations, and a conversion factor of 0.616505 for gas operations.

C. Results of Operations

26 The Company's results of operations for the 1998 test period form the basis of the analysis of results of operations. These results are adjusted for unusual events during the test period, and for known and measurable events, in order to reflect changes to the test year that will make it a better predictor of what the Company can expect its operations to cost in the rate year. (The rate year commences October 1, 2000). As a part of its filing, Avista provided a detailed portrayal of the restating actual and pro forma adjustments which the Company proposes to make to its 1998 results of operations. *WAC 480-09-330(2). Appendix B.*

27 "Restating actual adjustments," an accounting term, revise the booked operating results for any defects or infirmities that may exist in actual recorded results, which can distort test period earnings. Restating actual adjustments are also used to adjust from an as-recorded basis to a basis that is acceptable for rate making. Examples of restating actual adjustments are adjustments to remove amounts more appropriately attributable to a prior period, to eliminate below-the-line items that were recorded as

operating expenses in error, to adjust from book estimates to actual amounts, and to eliminate or to normalize extraordinary items which have been recorded during the test period. *WAC 480-09-330(2)(b). Appendix B.*

28 "Pro forma adjustments," another accounting term, give effect for the test period to all known and measurable changes which are not offset by other factors. *Id.*

29 Avista is required to identify dollar values and underlying reasons for each of the adjustments it proposes to its test year results. *Id.* The other parties may also present alternatives to the adjustments proposed by Avista, and sponsor other adjustments which they believe will make the test year results a better predictor of rate year expenses. Some adjustments are increases, and some are decreases; the decreases are shown in brackets in the tables. The net amount of total adjustments, when added to the test year net operating income (NOI[2]), gives the operating income on which Avista's rates will be based.

30 We will first catalog the uncontested adjustments for both electrical and gas operations, then discuss and decide the contested adjustments for both electrical and gas operations. All of the contested adjustments for gas operations duplicate the same adjustments for electrical operations (although there are several electrical issues that are not present in our analysis of gas operations). The same analysis will govern our determination of the contested issues. Tables 1-4 will provide the dollar impacts of the adjustments broken out for both electrical and gas operations.

1. Uncontested Adjustments

31 Many of the proposed adjustments to the 1998 results of operations have been agreed to by all of the parties presenting evidence on them. These uncontested adjustments are shown in the following two tables. The Commission has reviewed the proposed uncontested adjustments, and finds them to be reasonable for purposes of setting rates in this proceeding.

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[2] Net operating income is a company's operating revenues less operating expenses and federal income tax expense. It is the company's net income before interest expense is deducted.

Table 1 Table of Non-Contested Adjustments–Electric

Table 1 Table of Non-Contested Adjustments–Electric (Washington Jurisdiction) ($000)	
Non-Contested Adjustments - Electric	**Net Operating Income**
Colstrip 3 AFUDC Elimination	208
Kettle Falls Disallowance	108
Clearwater Hydro	0
Settlement Exchange Power	(3,325)
Eliminate B&O Taxes	(38)
Pro Forma Property Tax	83
Uncollectible Expense	(21)
Regulatory Expense	(80)
Federal Income Tax	(3,230)
Eliminate A/R Expenses	973
Office Space to Subsidiaries	16
Reclassify DADs/MOPs Revenue	0
Depreciation	(679)
Hydro Relicense	(1,413)
MOPs	(92)
Lease Expense	53
Pro Forma Revenue	1,557
Lost Revenue Efficiency	(663)
Total Non-Contested Electric NOI	(6,543)

Table 2 Table of Non-Contested Adjustments–Gas

TABLE 2 Table of Non-Contested Adjustments–Gas (Washington Jurisdiction) ($000)	
Non-Contested Adjustments - Gas	**Net Operating Income**
Eliminate B&O Taxes	$112
Pro forma Property Taxes	14
Uncollectible Expense	147
Regulatory Expense	(10)
Injuries and Damage	(29)
Federal Income Tax	(422)
Eliminate A/R Expenses	159
Office Space to Subsidiaries	4
Lease Expense	13
Depreciation	(51)
Pro forma Revenue	1,409
Hamilton Street Bridge	(97)
Total Non-Contested Gas NOI Adjustments	1,249

2. Contested Adjustments

32 Contested adjustments are those adjustments to the 1998 test year results of operations sponsored by one or more parties to the proceeding, and contested by one or more parties. Two tables of contested adjustments, indicating the positions of those parties taking a position, are shown below. In this section of the order the Commission will determine which of the adjustments should be allowed.

33 All of the parties used the same titles for adjustments in their accounting exhibits and their briefs. A useful listing of the electricity adjustments can be found on page one of Appendix 1 of Public Counsel's Brief. A similar listing of the gas adjustments can be found on page one of Appendix 2 of Public Counsel's Brief. For ease of comparison to the record, the Commission will use the same titles in Tables 1-4, although we will expand some of the titles for clarity. Several of the listed adjustments contain sub-parts on which the Commission must decide. We will organize the tables of contested adjustments in the order in which the contested issues are addressed in this order.

Table 3 Table of Contested Adjustments–Electric

Table 3 Table of Contested Adjustments–Electric (Washington Jurisdiction) ($000)				
Contested Net Operating Income Adjustments - Electric	Company	Commission Staff	Public Counsel	Commission
Pro Forma Power Supply (1)	(322)	2,496	7,638	(5,380)
PGE Contract (1A)	0	3,738	2,990	4,960
Icestorm Offset (1B)	1,331	0	0	0
Revenue from Market Transactions (1C)	380	0	380	380
Centralia Replacement Power Contract (2)	(3,645)	0	0	(3,645)
Potlatch Contract (3)	683	405	405	683
Injuries and Damages Account (4)	(1,514)	(32)	(32)	0*
Nez Perce Settlement Idaho Assignment (5)	(380)	(341)	(341)	(341)
Staff Miscellaneous (6)	202	370	370	292
Y2K Costs and Corporate Name Change (7)	679	849	849	748
Corporate Name Use Fee (7A)	NP***	NP***	1,450	0
Executive Compensation (8)	(386)	(83)	(83)	(113)
Team Incentive Bonuses (8A)	0	1,435	1,435	1,435
Administrative & General Salary (9)	NP***	NP***	1,242	0
Relocation Expense (10)	0	101	108	64
Hydroplant Depreciation (11)	NP***	NP***	1,776	0
Metering and Billing (12)	NP***	NP***	993	0
Franchise Fees and Excise Tax (13)	443	548	548	443
Pro forma Debt Interest**	(2,492)	(3,519)	(1,675)	(2,636)
Total Contested Electric NOI Adjustment				(3,111)

* ICNU proposed an adjustment of zero, which we adopt. We have not included a column for ICNU in this table because we were unable to tell if their proposed adjustment amounts were NOI or revenue requirement amounts, and whether they were Washington only or entire system.

** The Pro Forma Debt Interest Adjustment is an output that is determined by the amount and cost rate for debt decided on in the rate of return calculation. The adjustment pro forms the effect of the Commission's authorized weighted cost of debt on the Company's Federal Income Tax (FIT) expense. The parties agree that the adjustment should be made, and on how the adjustment should be made.

*** No Position

Table 4 Table of Contested Adjustments–Gas

Table 4 Table of Contested Adjustments–Gas (Washington Jurisdiction) ($000)				
Contested NOI Adjustments - Gas	Company	Commission Staff	Public Counsel	Commission
Staff Miscellaneous (6)	140	186	186	162
Corporate Name Use Fee (7A)	NP**	NP**	364	0
Y2K Costs and Corporate Name Change (7)	172	214	214	189
Executive Compensation (8)	(108)	(32)	(32)	(39)
Team Incentive Bonuses (8A)	0	282	282	282
Administrative & General Salary (9)	NP**	NP**	647	0
Relocation Expense (10)	0	25	27	16
Metering and Billing (12)	NP**	NP**	643	0
Franchise Fees and Excise Tax (13)	(459)	(73)	(73)	(459)
Pro forma Debt Interest*	(297)	(458)	(39)	(84)
Total Contested Gas NOI Adjustment				67

* The Pro Forma Debt Interest Adjustment is an output that is determined by the amount and cost rate for debt decided on in the rate of return calculation. The adjustment pro forms the effect of the Commission's authorized weighted cost of debt on the Company's Federal Income Tax (FIT) expense. The parties agree that the adjustment should be made, and on how the adjustment should be made.

** No Position

a. Pro Forma Power Supply Adjustment (1)

34 A major portion of the Company's overall costs are the costs to own and operate the Company's power supply resources, and to make power purchases necessary to supplement these resources so that service obligations are reliably met. Rates are set to recover the expected level of these costs based on costs incurred during the test year, adjusted for known and measurable adjustments to those costs, and normalized for expected loads, expected hydrological, and other operating conditions. This normalized level of power costs is established to represent typical conditions. Actual costs may vary significantly from year to year based on the actual levels of hydro-conditions, resource operations, loads, and off-system revenues.

35 Included in our findings regarding Pro Forma Power Supply, we will determine the outcome of contested adjustments regarding the Portland General Electric Contract, Icestorm Costs and Market Transaction Revenues. These appear as adjustments 1A, 1B and 1C on Table 3.

36 The Company documents $61,398,000 of system-wide net test year power expenses. It makes adjustments to these expenses of $1,034,000 to yield an adjusted pro forma net expense level of $62,432,000 for the rate year beginning October 1, 2000. Commission Staff and other parties have proposed a number of adjustments to the Company's pro forma power costs.

37 The matters in dispute include what should be included in test year expenses as normal costs and revenues, as well as what imputations and adjustments should be made to test year costs to reflect hydro-resource operational flexibility and margins estimated to be gained from wholesale market trading activity. In addition, the Company has asked to be allowed to implement a power cost adjustment mechanism

to flow through to customers the change in power costs associated with changes in hydrological and power market circumstances.

38 Table 5 documents the Company's proposed adjustments to power expenses and revenues, the adjustments recommended by Commission Staff, Public Counsel, and ICNU, and the level of adjustments approved by the Commission.

Table 5 Pro Forma Power Supply Costs

Table 5 Pro Forma Power Supply Costs ($000)					
***Expense Adjustments*:**	Staff	Public Counsel	ICNU	Commission System-basis	Commission WA Jurisdiction (e)
Company proposed:				**(316,180)(a)**	**(211,809)**
Wood Power Contract	(1,188)	(b)	NA	(1,188)	(796)
Potlatch Contract	(7,866)	(b)	NA	0	0
Rathdrum Lease	(5,786)	(b)	NA	0	0
Capacity Purchases	(955)	(b)	NA	(20)	(13)
Mid-Columbia Costs	(222)	(b)	NA	(222)	(149)
Colstrip Availability	(428)	(b)	NA	(428)	(287)
Fuel Cell Project	(71)	(b)	NA	(71)	(48)
Water Record / Dispatch Model	(5,900)	(b)	NA	(2,950)(f)	(1,976)
Dispatch Credit	(4,500)	(6,500)	NA	0	0
Total Expense Adjustment				**(321,059)**	**(215,078)**

Table 5 Pro Forma Power Supply Costs ($000) (Continued)					
***Revenue Adjustments*:**	Staff	Public Counsel	ICNU	Commission System Basis	Commission WA Jurisdiction (e)
Company proposed:				**(317,214)(a)**	**(212,502)**
PGE Capacity Contract	(16,200)(c)	(16,200)	(16,200)	(16,200)	(10,852)
Dispatch Credit	219	NA	NA	0	0
Market Transactions	5,151	NA	6,900	0	0
Total Revenue Adjustments				**(333,414)**	**(223,354)**
Net Expense Adjustment				12,355	8,276
Adjustment to NOI(d)				**8,031**	**5,380**

(a) - Exhibit 152, pp. 1-4
(b) - Public Counsel endorses Staff adjustment
(c) - Net of $(720) adjustment made by Company
(d) - NOI = Net Operating Income. Provision for 35% federal income tax.
(e) - Washington jurisdiction at 66.99% of system.
(f) - Per Stipulation. Ex. 740.

i. Portland General Electric Contract (1A)

39 The Company entered into a contract with Portland General Electric (PGE) on June 26, 1992, to provide electrical capacity to PGE on a long-term basis, to expire on December 31, 2016. (Capacity is the ability to call on generation to "back up" resources that supply power on an intermittent, unpredictable, or otherwise non-firm basis). Avista sold PGE 50 MW of capacity from November 1992 through October 1994 under the agreement. For the period November 1994 through 2016, this agreement provided for a fixed level of compensation for 150 MW of capacity,

resulting in an annual revenue stream to Avista ranging between $18 and $19 million. In 1995, the Company placed the 176 MW Rathdrum Turbine in service in 1995 to help serve capacity and energy needs, including its obligation under the PGE contract.

40 In 1998, the Company negotiated a series of agreements. It assigned to a subsidiary, Spokane Energy LLC, its responsibility to supply the contracted capacity to PGE through 2014, in return for a payment from Spokane Energy LLC of $145 million less transaction costs of $1.6 million for a net receipt of $143.4 million. This arrangement was completed on December 31, 1998. Spokane Energy LLC obtained the lump sum $145 million from an entity named the Spokane Energy Funding Trust, (also an affiliate of the Company) which holds Spokane Energy LLC's Note for the balance and on which Spokane Energy LLC pays interest at 8.45 percent per annum. The Note will mature in 2014. Both Spokane Energy LLC and the Spokane Energy Funding Trust are Corporations created in the state of Delaware. *Ex. 225.*

41 Avista has also established a contract with Enron Power Marketing (EPMI), also a Delaware Corporation, to sell to EPMI 150 MW of capacity, which EPMI in turn supplies to Spokane LLC, which in turn fulfills the obligation assigned to it by Avista to supply PGE 150 MW of capacity. *Id.*

42 The documents of record indicate that Mr. Ronald R. Peterson serves as Vice President and Treasurer for both Avista and Spokane Energy LLC. His signature appears for Avista and Spokane Energy LLC on documents and contracts in which both entities are parties. His signature also appears on contracts between Spokane Energy LLC and the Spokane Energy Funding Trust, and on contracts between Spokane Energy LLC and EPMI. In the latter case he represents Avista as Manager of Spokane Energy LLC. *Id.*

43 Instead of receiving the original revenue stream of between $18 and $19 million, Avista utilities now receives $1.8 million per year from Spokane Energy LLC in return for Avista's performance as a "servicer" of the set of arrangements. The original contract with PGE and expected contract revenues remain in place for 2015 and 2016, the final two-years of the original contract period.

44 The PGE Contract was a wholesale power transaction and the Company reported, as required, modifications to this transaction to the Federal Energy Regulatory Commission on September 8, 1998. In this report to FERC, the Company included a

description of its plans concerning retail ratemaking for the transactions. It also noted the transaction in its 1998 form 10-K and its 1998 Annual Report, characterizing the lump sum proceeds as a loan that is amortized through 2014. The Company made no specific report or filing to the Commission concerning the details of the transaction(s), its intended ratemaking treatment, or its decision to treat the lump sum proceeds as an amortizing loan balance. It began to amortize the proceeds beginning January 1, 1999. The Company argues that it was not required to report or undertake any filing with the Commission concerning the transaction or its accounting practices related to the transaction.

45 In this proceeding the Company did not describe the details of the transaction(s) in its tariff filing, or in its direct case. It included the original level of contract revenues—$18 million—as a credit in its test year power expenses.

46 The Company's proposed ratemaking treatment was strongly attacked by Commission Staff, Public Counsel, and ICNU. All three parties argue that the normalized power costs to be established in this proceeding should reflect the actual level of revenue received by the Company under the contract—$1.8 million annually—and that the lump sum payment received by the Company in return for assignment of the capacity obligation to its affiliate should be credited to ratepayers today, not as revenue credited against power costs over the 14-year period proposed by the Company. In addition, all three parties object that the Company did not fulfill its responsibility to report the details of the transaction(s) to the Commission and did not request, or receive, authorization to amortize the $143.4 lump sum as a loan.

47 Commission Staff recommends that the net proceeds of the transaction(s)—$143.4 million on a system basis and $96 million on a Washington jurisdictional basis—be used to offset a number of expenses and obligations related to power costs and rate base on the Company's books. These include: buying out of the remaining balance in the Rathdrum Lease; offsetting the costs of the Wood Power Contract buyout; adjusting the revenues and costs of the Potlatch Contract; eliminating the DSM regulatory asset (rate base); covering the up-front payment made in the Nez Perce Settlement; and applying the balance to general rate base reduction, amortized over 14.25-years. Staff states that, if this treatment is approved, any and all of its issues concerning prudence of any of the offset items are discharged.

48 Commission Staff argues that the time value benefit of the proceeds over the 21-month period from December 31, 1998, to October 1, 2000 (the beginning of the rate period) should be credited to ratepayers at a cost of capital equal to Staff's proposed level in this case—8.64 percent. This time value amounts to an additional $22.5 million on a system-basis and $15.1 million on a Washington basis.

49 In support of its proposal, Commission Staff argues that:

50 (1) "The transaction between WWP (now Avista Utilities) and Spokane Energy LLC was not an 'arms length' transaction. It involved a complex series of agreements between Avista and two affiliates as well as Enron Corporation and several of its affiliates. In fact, the agreement is signed on behalf of Avista and Spokane Energy by the same person, Ronald, R. Peterson, and WWP (now Avista Utilities) acts as the manager of Spokane Energy." *Commission Staff Brief, p. 48.*

51 (2) Avista's proposed ratemaking treatment ". . . is premised on a contractual arrangement that has not existed since 1998. . . It is premised on a fiction." *Commission Staff Brief, p. 49.*

52 (3) Commission Staff's proposed pro forma adjustment, ". . . adjusts the test year revenues to account for known and measurable changes—in this case, the Company's known receipt of $143.4 million and annual revenues of $1.8 million." *Commission Staff Brief, p. 50.*

53 (4) The Company has received the benefit of interest on the cash-in-hand since receiving the payment from Spokane Energy LLC. In addition, over the 14-year period proposed by the Company, the present value of the $18 million of imputed annual revenue to be credited to customers equals the $143.4 million lump sum payment received, only if a relatively low discount rate of 7.83 percent is assumed. If one uses a higher discount rate equal either to the Company's current authorized rate of return of 10.67 percent, or to a discount rate more reflective of a customer perspective, then the present value of the Company's proposal to recognize $18 million of imputed revenue over 14-years is substantially less than the $143.4 lump sum payment. "Yet, under the Company's proposal none of these additional benefits are recognized and flowed through to the ratepayers." *Commission Staff Brief, p. 51.*

54 (5) Commission Staff argues that benefits of the transaction should be flowed to ratepayers because: "This is the standard ratemaking approach: revenues from the sale of power should be flowed through to the ratepayers since the customers have paid the cost of the facilities that generated the sales." Staff notes that when the Company has incurred a cost to buy down or buyout an obligation, it has requested recovery of that cost from ratepayers, citing the request of the Company in this proceeding to recover the buyout costs of the Wood Power contract. *Commission Staff Brief, p. 52.*

55 Finally, Commission Staff objects to the lack of notice provided to the Commission concerning the transaction(s). Staff argues that the Company's reliance on FERC filings and on notes in its 10-K and Annual Reports is "wholly inadequate." Staff also points out that since the transaction involved an affiliate, the Company was required to make a filing under Chapter 80.16 RCW – Affiliate Transactions, and that no such filing was ever made.

56 For its part, Public Counsel also objects strongly, noting: ". . . the single most troubling element in the Company's rate filing is its failure to disclose or properly account for the test year buydown of the contract with Portland General Electric (PGE) for peaking capacity." *Public Counsel Brief, p. 3.* Public Counsel notes that the Company neither notified the Commission of this transaction(s) nor sought an accounting order approving the accounting treatment the Company has undertaken.

57 According to Public Counsel, there is a direct linkage between the Rathdrum Turbine costs and the PGE capacity contract. He argues that this linkage needs to be recognized in this proceeding because the Company is proposing to recover costs associated with the Rathdrum Turbine. Public Counsel argues that the lump sum proceeds should be flowed to ratepayers because "under decades of regulatory history, revenues from off-system power sales have been used to reduce the share of total power costs borne by ratepayers." *Public Counsel Brief, p. 5.* According to Public Counsel, the $18 million in revenue the Company proposes to include in pro forma power costs is "simply wrong." "The Company will not receive this amount of money for this transaction on a going forward basis . . . The contract has been amended, and those changes are known and measurable. The $18 million in annual revenues have been replaced with a $143 million one-time cash payment, plus a $1.8 million annual payment." *Public Counsel Brief, p. 6.*

58 Public Counsel supports the adjustments proposed by Commission Staff to address: the cost of the Rathdrum Turbine lease; the Wood Power Contract buyout; adjustments to the revenues and costs of the Potlatch Contract; the DSM regulatory asset (rate base); and a credit against rate base. Public Counsel argues that the cash balance used for these offsets should include the interest benefit of the lump sum payment from December 31, 1998 through October 1, 2000.

59 Finally, Public Counsel believes that the Company should "face consequences" for its failure to report the transaction, but he does not support ICNU's proposal to disallow recovery of Washington regulatory fees as a penalty. Public Counsel believes it would be sufficient and appropriate to assess the interest on the cash received and disallow the requested 25 basis point "equity kicker" because of "improper regulatory treatment" of the PGE contract.

60 ICNU also argues that it is inappropriate to pro form the $18 million of revenue that is no longer being received under the reformed PGE contract and that it is inappropriate to amortize the $143.4 million lump sum proceeds over 16-years as proposed by the Company. According to ICNU, the effect of the ". . . assignment of the PGE contract is a known and measurable change to the test year that should be reflected in the pro forma revenue requirement." *ICNU Brief, p. 17.* ICNU recommends that the revenue requirement should reflect the $1.8 million in revenue actually received by Avista, and that the cash proceeds from the assignment, plus accrued interest adjusted for 6 months of amortization expense be used to "reduce or credit the test period rate base" so that the total is amortized over eight years. *ICNU Brief, pp. 17-18.* ICNU neither supports nor opposes Staff's recommendation to use the proceeds to offset other power related expenses and rate base.

61 ICNU represents that Avista was required to file the details of the PGE Contract restructuring transactions with the Commission as affiliate transactions under RCW 80.16.020. In addition, if the transaction is properly considered a loan, as the Company claims, Avista was required to make a filing to the Commission under RCW 80.08.040 (as evidence of indebtedness). Also, ICNU points out that WAC 480-146-360 requires companies to file an annual report of all affiliate interest transactions and the Company also failed to fulfill this obligation.

62 ICNU asks the Commission to consider the Company's proposal for treatment of the PGE contract and test year buydown proceeds in light of this failure to meet statutory reporting requirements and to further consider imposing a penalty by disallowing recovery of the Company's Washington regulatory fees.

63 On rebuttal, and in its Brief, the Company defends its proposal and objects to the proposals of Commission Staff, Public Counsel, and ICNU. The Company argues that it ". . . was not required to provide documents regarding the PGE transaction to Commission Staff and none were provided." *Ex. 224; Tr. 1609:17-25.* Elaborating on this point in its Brief the Company states,

> While the Company might have done more to earlier inform this Commission (although not technically required to do so), there is simply no basis for ICNU's recommendations for a "penalty" by means of a denial of recovery of regulatory fees or the Company's request for an equity adder. *Avista Brief, p. 16*

64 The Company is silent concerning the specific allegations of ICNU that Avista was required to file information with the Commission under affiliate interest statutes and rules or because it has treated the transaction as a loan.

65 Avista argues that the only purpose of the PGE Contract transaction(s) was to secure the benefits of its above-market sale of capacity to PGE in order to ensure that customers continued to realize these benefits over the life of the original contract. According to the Company, the lump sum payment of a net $143.4 million represents the present value of the revenue that would have been received through 2014 using a discount rate of 7.83 percent. It represents that the proposal for offsets made by Commission Staff dramatically accelerates the benefits of the transaction, to the detriment of ratepayers in the future. The Company argues that Staff's proposal to use the entire value of the lump sum payment it received to offset other power cost items and rate base would cause it to incur a "write-off" of $9.3 million, because this is the amount by which the original sum will have already been amortized for the period January 1999 to October 2000 in the deferral account the Company established. Further, it argues that the offsets proposed by Staff represent ". . . in essence, a taking of property and an attempt to 'micro-manage the utility' in that it would have this Commission substitute its judgment for that of Company management with regard to the financial decisions associated with the monetization proceeds." *Avista Brief, p. 14.* The Company particularly objects to the Staff's

proposal to use a portion of the cash proceeds to buyout the balance of the Rathdrum Lease because, according to Avista, this would eliminate the benefit of a favorable interest rate and lease terms.

66 After emphasizing that it opposes the approach proposed by Commission Staff, the Company states that should the Commission decide to approve this approach, a number of adjustments need to be made. First, the amount available to apply as offsets needs to be adjusted to reflect the actual balance in the deferral account (i.e., net out the amount by which the balance has already been amortized between January 1999 and October 2000). The Company represents that this balance is properly $129.5 million (on a system basis) for October 1, 2000. Second, the first use of the deferred revenue balance should be to offset the Company's Icestorm costs ($15.3 million system, $12.3 million WA). Third, if the Commission rejects use of the deferral balance to offset Icestorm costs, 15 percent of the October 1, 2000, balance should be awarded to shareholders as ". . . some measure of meaningful benefit for creating this value for customers." Fourth and finally, write off the up-front Nez Perce settlement payment ($2.4 million system, $1.6 million WA) and eliminate DSM rate base and amortization ($31.9 million system, and $21.4 million WA).

Commission Discussion and Decision: Compliance with RCW 80.16.020.

67 The Commission is troubled by Avista's handling of the PGE test year buydown transactions. The Company did not disclose this transaction in its case-in-chief and it was only through the diligence of the Staff and ICNU investigations that the nature and details of this transaction came fully to light. Even after ICNU and Staff raised the statutory requirement to file for approval of transactions with affiliated interests, the Company continued to assert in its Brief that it was not required to file or even notify the Commission of this set of arrangements. In fact, it never addresses the question specifically of whether it was required to request approval from the Commission to enter a transaction with an affiliated interest.

68 We disagree with the Company's assertions that it had no obligation to fully report these transactions to this Commission. The evidence of record indicates that this was a transaction, or series of transactions, requiring approval under RCW 80.16.020. Some of the documents that effectuate the transaction were signed by the same individual, representing both contracting parties. Company witness Mr. Norwood confirmed that Spokane Energy LLC is a subsidiary of Avista. *TR-1609.*

69 The Commission finds that the Company should make an affiliated interest filing regarding this transaction(s) no later than December, 2000. That filing must include all relevant contracts and documents that effectuate the transaction(s) and assignments of interests and obligations. In addition, the company must include all documents relating to evaluation of risk of default in the original PGE Contract and valuation of the sum to be accepted by Avista in lieu of the revenue that would have been received by Avista under the PGE Contract. Alternatively, if the Company believes it is not required by statute to report this transaction under RCW 80.16.020, we expect it to file with the Commission a request for such a finding.

70 While we are troubled by Avista's failure to inform and seek approval from the Commission regarding changes in the PGE Contract, we will not impose the penalty of disallowance of regulatory fees sought by ICNU. The Commission has authority to penalize companies under RCW 80.04.380 through 80.04.405. We do not impose penalties other than in form and process set by these sections.

Commission Discussion and Decision: PGE Contract Revenue

71 It is clear that the former level of PGE Contract revenue of $18 to $19 million per year is no longer the case, and that the actual annual level of revenue is $1.8 million.

72 The Commission is concerned by Avista's proposal regarding accounting treatment for the PGE contract test year buydown. The contract test year buydown was a known and measurable change to the test year results of operations, and should have been disclosed in the Company's direct case as a pro forma adjustment. If Avista wished to impute a level of income from the PGE contract which is no longer being received, it should have proposed such an adjustment with full disclosure.

73 The Company has demonstrated that the combination of the original PGE Contract and the Rathdrum Turbine provided substantial benefits to customers (i.e., the contract generated more revenue than the sum of the lease payments and operating costs of the turbine). No party disputes this.

74 The issue is treatment of the contract restructuring and the appropriate way to account in rates for the lump sum payment and the reduction in revenue actually received. The Commission is not persuaded by Avista's argument that $18 million in annual

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revenue should be imputed to net power costs, when only $1.8 million is being received. The Commission agrees with Commission Staff, Public Counsel, and ICNU that a pro forma adjustment to Avista's 1998 results of operations should be made to reflect the new PGE contract terms. We approve pro forma power revenues that are reduced by $16,200,000 to reflect the difference between the $18,000,000 of annual revenue imputed by the Company and actual revenue of $1,800,000.

Commission Discussion and Decision: Disposition of PGE Contract Test Year Buydown

75 The Company has chosen to monetize in a present lump sum the benefits ratepayers would have received from the PGE capacity contract over time. The Company negotiated the value to be received, and, because no filing was made for the Commission to evaluate whether the interests of ratepayers were preserved, we are left now to decide how best to recognize the ratepayer interest in the proceeds of the transaction. We conclude that application of the lump sum so as to reduce rate base and so as to offset certain expenses that would otherwise increase rates, best serves customers' interests, and the public interest, currently and in the long-term.

76 The Commission agrees with Staff, Public Counsel, and ICNU that the time value of the lump sum payment received by the Company in December 1998 should be reflected in the balance of funds available on October 1, 2000, and should be used to accomplish certain offsets. Finally, the Commission agrees with the Company that the balance available on October 1, 2000, should reflect expenses incurred by the Company for the Rathdrum Turbine that are no longer being covered by PGE Contract revenue. The Commission finds these expenses to be equal to the amortization expense, cited by the Company, of $9.3 million for the Washington jurisdiction. The table below demonstrates the Commission's calculation of funds available to apply to offsets effective October 1, 2000.

Table 6 Funds Available to Apply to Offsets

Table 6 Funds Available to Apply to Offsets		
	System	**Washington**
Net Lump Sum Test Year Buydown Received By Avista December 1998	$143.4 M	$96.1 M
Time Value at Note Rate 8.45% (Ex. 225)	$21.2 M	$14.2 M
Expenses Incurred January 1999 through September 2000	$(13.9) M	$(9.3) M
Total Available for Offsets	$150.7 M	$100.9 M

77 The following eight issues concern use of the PGE funds. They are adjustments proposed by Commission Staff, or the Company, regarding costs to be offset if the PGE restructure funds are to be used to accomplish offsets.

1. Wood Power Contract
2. Potlatch Contract Adjustment
3. Rathdrum Lease
4. DSM/Weatherization Rate Base
5. Nez Perce Settlement Payment
6. Icestorm Costs
7. Shareholders Receive 15-percent of Balance
8. Ratepayers Receipt of Balance

1. Wood Power Contract

78 Avista bought out an above-market power contract with Wood Power Incorporated in 1996. In the process Avista incurred a cost of $9.5 million. It notified Commission Staff of this transaction by letter and indicated it would amortize the cost for reporting purposes over eight years beginning in 1997. Avista did not file for approval of the accounting treatment, so a regulatory asset was not formally created. The Company's original filing in this proceeding neglected to include the unamortized balance in rate base, but did include the annual amortization expense of $1,188,000.

79 Commission Staff has proposed that proceeds from the PGE contract test year buydown be used to eliminate the Wood Power annual amortization expense from test year power costs and that the remaining $5 million (system) in unamortized contract termination costs not be included in rate base.

80 The Company makes no specific objection to this treatment other than its general objection that PGE test year buydown proceeds should not be used to offset other costs and rate base items. The Company indicates that if the Commission decides to order offsets over its objection, then it does not object to Staff's proposed treatment of the Wood Power termination costs.

81 Commission Staff, Public Counsel, and ICNU all observe that the Company did choose to notify the Commission that it had incurred this cost to reform or buyout a contract, in contrast to its providing no notification to the Commission when it secured a benefit (in terms of up-front cash) from its test year buydown of the PGE contact.

Commission Discussion and Decision

82 The Commission finds appropriate Staff's recommendation to use PGE contract test year buydown funds to eliminate the balance and annual amortization expense associated with the Wood Power Contract buyout. The Company did notify Staff at the time this transaction took place and no evidence has been presented to cast doubt on whether the buyout of the Wood Power Contract was in the interest of ratepayers.

83 This removes $795,941 in annual amortization expense from Washington jurisdictional power expenses. A total of $3,380,897 of the proceeds of the test year buydown are allocated to the Company to offset the unamortized balance of the cost of the Wood Power Contract buyout.

2. Potlatch Contract Adjustment

84 Avista has a power purchase contract with Potlatch that obligates Avista to purchase power at 48 mills per kWh through the end of December, 2001. The record is silent on whether a continuation of this contract has been negotiated, or whether Avista will pursue continuation.

85 Commission Staff argues that the 48 mill rate is "above market" and would be inappropriate to include in normalized power expenses since the contract is due to expire next year. Staff proposes to make an adjustment to test year power costs to reflect a lower rate—Staff proposes 29.7525 mills/kWh—and to allocate a portion of the PGE test year buydown proceeds to make the Company "whole" for the difference between 48 mills and 29.7525 mills over the remainder of the existing contract term.

86 The Company does not make a specific objection to this adjustment other than its general objection that PGE funds should not be used for offsets.

Commission Discussion and Decision

87 The Commission does not find Staff's recommendation regarding the Potlatch contract to be an appropriate use for the test year buydown funds. The Staff's recommendation requires imputation of a contract rate that has not been negotiated for the existing contract term, or for any continuation of the contract between Potlatch and Company. This rate is not known and measurable, and therefore we do not find it to be an appropriate adjustment to pro forma costs. We recognize Staff's objective is to avoid embedding this contract cost in rates when the contract is set to expire in the near future. However, in light of our decision to adjust power rates on a temporary basis, the Company will file a power supply case in the second half of 2001, and the expiration or renegotiation of Potlatch contact costs will likely be known by that time. Because we have not approved Staff's adjustment to the contract rate, we will also not approve Staff's proposal to allocate some portion of the PGE contract test year buydown funds to "keep the Company whole" for any such adjustment through the end of the current contract term.

3. Rathdrum Lease

88 Avista financed the 175 MW gas-fired combustion turbine installation in Rathdrum, Idaho in 1995 through a lease arrangement that did not require the Company to provide construction capital. The Company makes an annual lease payment in return for its control, operation, and benefit of the facility. The annual lease payment is $5,786,000 and the lease balance is approximately $55 million ($3.8 million and $37 million respectively, on a Washington jurisdictional basis). The Company has proposed that the annual lease payment be included in normalized power expense.

89 The Company provides substantial evidence regarding the cost and benefits associated with the Rathdrum Plant. *Ex. 171.* In particular the Company notes that the Rathdrum Plant, coupled with the PGE contract, provided approximately $9 million in annual system-wide net benefits. No party has disputed the evidence presented by the Company concerning Rathdrum costs and benefits. Public Counsel notes that, aside from the relationship between the contract revenue and the costs of Rathdrum, the Company has not otherwise demonstrated that the decision to acquire the Rathdrum generation resource was prudent. He argues that in order for the acquisition of the Rathdrum generation resource and its on-going costs to be considered prudent and recovered in rates, the close relationship between the PGE Contract and the Rathdrum Plant requires the monetized benefits of this relationship to be flowed through to ratepayers.

90 Commission Staff represents that the Company has "... made no filing in this jurisdiction regarding the proper ratemaking treatment of the Rathdrum Lease. In addition, the Company has made no filing in regard to the prudence of acquiring Rathdrum." *T-540, pp. 23, 11, 17.* However, Staff proposes that it will not pursue the issue of prudence if proceeds from the PGE test year buydown are used to buyout the balance in the Rathdrum Lease. The consequence would be that the Rathdrum combustion turbine remains in Avista's resource portfolio and that Rathdrum's operating costs remain in normalized power expense. The cost to finance its acquisition is paid off.

91 Staff's proposal would remove $5,786,000 (the lease payment) on a system basis from test year power costs, and dedicate $37,031,000 of the test year buydown funds to buyout the lease balance.

92 In its Brief, Commission Staff recommends that if the Commission chooses to maintain the current lease payments and not apply the test year buydown funds to the lease balance for ratemaking purposes, an equal amount of funds ($37 million) should be applied toward reducing Avista's generation rate base.

93 The Company objects that the terms of the Rathdrum lease represent very attractive financing. It argues that Commission Staff's recommendation "... was made without the benefit of any analysis of costs or benefits associated with buying out of the lease." *T-203, pp. 14 l. 14.* The Company represents that the current lease arrangement provides financing at 5.26 percent, while "... under current

circumstances, the after-tax cost of financing the Rathdrum generating plant would be 8.81 percent. . ." *Tr., p. 1263.* According to Avista, this differential in financing costs equates to a difference of $46 million over the remaining 20-year term of the lease.

Commission Discussion and Decision

94 The Company presents persuasive evidence that acquisition of the Rathdrum generating resource was and is beneficial to ratepayers. We note that no party has taken direct issue with this evidence, and therefore we find the acquisition and its financing to have been prudent.

95 The Company argues that the financing arrangement continues to be beneficial because of its low interest rate. We agree and do not accept the Staff recommendation to buyout the lease balance. Instead, a like amount, $37 million, of the PGE test year buydown balance should be used to reduce rate base. A reduction to generation rate base reflects that, while the Rathdrum plant contributed to Avista's supply of capacity under the PGE contract, the whole of the Company's generation portfolio stood behind this obligation. This $37 million reduction to rate base is reflected in the Contested Rate Base adjustments in our order.

4. Demand Side Management Programs

96 This matter concerns a rate base adjustment, rather than an adjustment to operating expense, but because it is related to the PGE test year buydown balance and offset issue, we have included it here and will also note it as an adjustment to rate base in the Contested Rate Base section of this order.

97 Pursuant to prior Commission authorization in Schedules 91 & 191, the Company is required to demonstrate the prudence of its energy efficiency programs and expenditures at the time of a general rate case. Since 1995, the Company's energy efficiency programs have saved over 72 million kilowatt hours at a cost below the avoided cost of electricity and natural gas, respectively. Avista has approximately $35 million in rate base on a system basis ($21.4 million in Washington jurisdiction) related to Demand Side Management (DSM).

98 The Company proposes in its rebuttal case that if an offset approach is adopted, PGE proceeds should be applied to buyout this component of rate base. No party objected and Commission Staff has adopted this proposal in its position on Brief.

Commission Discussion and Decision

99 At the recommendation of both Commission Staff and NWEC, the Commission finds prudent the Company's energy efficiency programs and expenditures. The Commission finds appropriate the application of $21.4 million of the available balance of PGE contract test year buydown funds to eliminate the rate base balance associated with DSM and Weatherization expenditures. This treatment not only benefits the ratepayers, but may also benefit the Company and the Commission by eliminating a regulatory asset from the Company's books.

100 The Commission approves use of $21,407,750 of PGE contract test year buydown proceeds to buyout this component of the rate base.

5. Nez Perce Settlement Up-front Payment

101 This matter concerns a rate base adjustment, rather than an adjustment to operating expense, but also relates to use of PGE revenue. We will include this adjustment in the Contested Rate Base section of our order.

102 As a part of settling a lawsuit with the Nez Perce Tribe, Avista made an up-front payment of $2.5 million. The Washington share of this payment is $1.6 million. Avista began amortizing this sum over 45-years in 1999.

103 This adjustment involves only the up-front payment of the Nez Perce Settlement. The annual expenses of the Settlement and related issues are discussed beginning at paragraph 208.

Commission Discussion and Decision

104 The Company proposed on rebuttal, and the Commission Staff concurred on Brief, that if an offset approach is approved, this balance should also be "cleaned" off the Company's books.

105 We agree with the Company and Staff. The Commission finds appropriate the application of $1,609,636 of the available PGE contract buydown balance to eliminate the balance associated with the initial payment made under the Nez Perce Settlement. Like the DSM/Weatherization rate base, the Nez Perce balance represents a regulatory asset that can, with these offset funds, be beneficially removed from the Company's books.

6. Icestorm Offset (1B)

106 Avista proposes that PGE contract buydown proceeds be used to recover the costs associated with a 1996 Icestorm that damaged the Company's transmission and distribution system. According to Avista, those costs amount to $12.3 million for the Washington jurisdiction.

107 Public Counsel, Commission Staff, and ICNU all object that Icestorm costs should not be recovered. According to the Parties, these costs were associated with an extraordinary event, and the Company indicated at the time that rates would not be increased as a result of the Storm. The parties argue that if the Company wanted to recover these costs, it should have filed for approval of special accounting treatment at the time. According to the parties, to pro form them into test year costs at this point amounts to retroactive ratemaking.

108 The Company argues that these costs were prudently incurred and that its statements at the time of the Icestorm regarding recovery in rates meant that it would not seek a rate surcharge. It maintains it always intended to seek recovery at a future date.

Commission Discussion and Decision

109 The Company's proposal to recover costs associated with the 1996 Icestorm is addressed in detail under adjustments to the Injuries and Damages Account at paragraph 200. The Commission agrees with Staff, Public Counsel, and ICNU that the balance of funds available from the PGE Contract test year buydown should not be used to cover the Icestorm costs.

7. Allocation of 15 Percent of PGE Test Year Buydown Balance to Shareholders

110 The Company recommends that if the lump sum payment received as the test year buydown of the PGE Contract is to be used to offset other expenses and rate base balances, and if the Commission does not permit a share of these funds to offset Icestorm costs, then 15 percent of the lump sum should be allocated to shareholders, as a reward for the Company's action creating value for customers through the transaction.

Commission Discussion and Decision

111 The Commission is not persuaded that the Company's decision to buy down the PGE contract created any new value for customers. While Avista argues that the revenue stream for this contract was at risk, it provides only assertions of this risk but no direct or persuasive evidence of such a risk. If the contract had remained in place, customers would have continued to receive its benefits, coupled with the Rathdrum Plant, at the levels the company has demonstrated. Test year buydown of those benefits created no demonstrated increase in value, and therefore we find no basis for entertaining Avista's request to award the shareholders a portion of benefits that otherwise would have flowed to ratepayers. We also, therefore, reach no conclusion as to whether such an award would be appropriate if there *were* a demonstrated increase in value. Moreover, we are disturbed by the Company's failure to make the filings required by law, which would have allowed us to examine whether this affiliated transaction resulted in a lump sum payment at least equal in value to the benefits the customers would have realized over time. We reject the Company's request for a share of the balance of the test year buydown transaction proceeds.

8. Credit of Remaining Balance of PGE Contract Test Year Buydown to Customers

112 The Commission Staff recommends that the balance of funds from the PGE Contract buydown not directed to specific offsets or rate base reductions be credited to the benefit of ratepayers as deferred revenue amortized over 16-years. On Brief, Staff modifies this recommendation to be 14.25-years to reflect that the buydown is to be effective through the year 2014, which does not include the final two-years of the original PGE Contract.

113 Public Counsel recommends that the balance of funds not otherwise used for offsets or rate base reductions be credited to ratepayers over 16-years.

114 ICNU recommends that the balance of funds received for the buydown be used to "reduce, or credit the test period rate base" by the amount of the lump sum received and allow for an eight-year amortization. ICNU argues that the eight-year period better reflects that customers (in their own business matters) typically have a higher discount rate than the Company employed in calculating the $143.4 million value for the future benefits. Therefore, ICNU argues, the benefits should be credited over a shorter period of time.

Commission Discussion and Decision

115 We agree with ICNU regarding credit to ratepayers of the balance of funds not otherwise directed to offsets or specific rate base reductions. This balance should be credited against test year rate base and amortized straight-line over eight years. This results in an adjustment increasing net operating income by $4,960,000 labeled as "PGE Contract" on Table 3.

9. Summary of Treatment of PGE Contract Test Year Buydown

116 Table 7 summarizes the Commission's decisions concerning the disposition of the PGE Contract Test Year Buydown Funds.

Table 7 Disposition of PGE Contract Test Year Buydown

Table 7 Disposition of PGE Contract Test Year Buydown (Washington Jurisdiction) ($000)	
Balance of Funds WA Jurisdiction	100,957
Eliminate Wood Power Balance	3,381
Reduce Generation Rate Base	37,030
Eliminate DSM/Weatherization Balance	21,408
Eliminate Nez Perce Balance	1,610
Credit Against Rate Base Amortize Over 8 Years.	37,528

276

ii. Cost of Purchased Capacity

117 Avista included $955,000 in system-wide annual expenses for capacity purchases in its test year pro forma power expense, based on the actual cost of short-term capacity purchases it made during 1998. Short-term capacity is the ability to call on generation to "back up" resources that supply power on an intermittent, unpredictable, or otherwise non-firm basis.

118 Commission Staff recommends that this expense be removed from normalized power costs because the Company has provided no justification for the amount documented, or for the ". . . specific capacity levels represented by this pro forma expense amount." *Staff Brief, p. 66.* Staff argues that while these expenditures may indeed have occurred during the test year, the Company has failed to justify the need for capacity purchases for a ". . . normalized test year." *Id., p. 67.* According to Staff, there is nothing in the Company's documentation that permits capacity purchased to support firm load requirements to be distinguished from capacity purchased to support commercial trading activity. Further, there is no analysis to show the contribution short-term energy purchases may make to capacity needs. *Id., p. 67.*

119 Public Counsel endorses the Commission Staff position on this issue but provides no evidence or arguments of its own.

120 The Company provided an inventory of its 1998 capacity purchases, historical data concerning its capacity purchases, and a tabulation of resources and loads from its least cost plans. *Exs. 211 and 212.* The Company argues that these purchases are necessary to meet the firm load obligations and are not related in any way to the short-term commercial trading transactions. Moreover, it argues that through its least cost planning process, the Company has analyzed the strategy of relying on short-term rather than long-term capacity purchases and found it to be the least costly alternative. Finally, it points out that the $955,000 included in the pro forma power expense is based on actual 1998 purchases. The five-year average of such purchases is $935,000. *Id.* The Company would not object to using this five-year average, rather than the 1998 figure.

Commission Discussion and Decision

121 The Company did spend $955,000 level on short-term capacity purchases during the test period, and it has demonstrated that the test year level of expense is consistent with a five-year average. Moreover, the Company has, through its least cost planning process, discussed with its customers and Commission Staff its reliance on short-term capacity purchases. We note and appreciate the Staff's point that the least cost planning process is not the appropriate forum for approval of any specific level of power cost expense. We have repeatedly stated in other decisions that least cost plans do not constitute pre-approval of expense levels. However, these plans do constitute meaningful evidence that we will consider when we examine expense levels. In this instance, we find persuasive the resource planning information, coupled with the Company's record of actual expenses over five years.

122 We agree with Staff that the Company's current power dispatch model does not measure the levels or cost of a "normal" level of capacity purchases. This is one of a number of reasons why we have directed that the Company implement a more sophisticated model and file a new power supply case in 2001. See paragraphs 138-144.

123 The five-year average of $935,000 for short-term capacity purchases documented by the Company will be included in rates on a temporary basis. We expect the new power supply model to measure and provide a normalized value for capacity purchases. The adjustment to pro forma power supply costs in Table 7 reflects the $20,000 modification to reflect that the average of costs over five years was lower by this amount than the test year costs.

iii. Colstrip Availability Adjustment

124 As an input to its power dispatch model, Avista assumed an availability factor of 83 percent for Colstrip coal-fired generation units 3 and 4. According to Avista, this value is close to the actual 82.1 percent average availability of those units over the 14-year period the units have been in service. In addition, the Company provides evidence, based on data compiled by the North American Electric Reliability Council (NERC), that the average equivalent availability factor for major generating projects across the country was 82.98 percent for the period 1994 through 1998.

125 Commission Staff proposes to increase the equivalent availability factor for the Colstrip units 3 and 4 to 86 percent. Staff argues that the 83 percent value proposed by the Company is inappropriately low, due to inclusion of a "data anomaly" in 1993. Staff points out that a transmission outage in December of 1993 resulted in an uncharacteristically low availability factor for unit 3 in that year. *T-162, p. 1.* Based on Colstrip data calculated for 1994 through 1998, Staff witness Alan Buckley asserts that availability in the range of 85 to 95 percent is appropriate for these units. *T-216, p. 1.* According to Staff, its proposed value of 86 percent ". . . results in a value that best represents the most current operating practices." Moreover, according to Staff, it is better to use these actual data than those drawn from national averages compiled by NERC.

126 Staff's adjustment reduces power supply net expense by $428,400 on a system basis, or $286,985 for the Washington jurisdiction. *T-203, p. 60, ll. 20-21.*

127 Public Counsel adopts Commission Staff's recommendation, but offers no additional evidence or argument.

Commission Discussion and Decision

128 Exhibit 215 clearly demonstrates that the average availability over 1994 - 1998 is 86.9 percent for the Colstrip units, even if the national average was 82.9 percent. The years 1993 (and 1987) are clearly unusual in the 14-year record. We agree with Commission Staff that the more recent data are a better representation of actual typical performance. We note that the actual test year availability factor was 89.7 percent, significantly above Staff's recommended level of 86 percent. Data for 1999 is even higher at 94.6 percent. Avista should use an availability factor of 86 percent for Colstrip units 3 and 4 in its power dispatch model.

129 We approve the adjustment recommended by Staff which reduces pro forma power supply expenses by the net amount of $428,000 on a system basis and $287,000 on a Washington jurisdiction basis.

iv. Mid-Columbia Project Adjustment

130 The Commission Staff recommends that the pro forma power supply costs filed in the Company's case-in-chief be reduced by $222,000, in order to reflect the most recent

estimates of operational cost for the Wanapum and Priest Rapids Columbia River hydroelectric projects made by Grant County Public Utility District, the project owner. For its part, the Company does not object to this adjustment and accepted it on rebuttal. No other party provides evidence on this issue.

Commission Discussion and Decision

131 The Commission approves the $222,000 (system) and $149,000 (Washington jurisdiction) adjustment to pro forma power supply costs, in order to reflect the most recent estimates of cost for the Wanapum and Priest Rapids mid-Columbia hydroplants.

v. Fuel-Cell Project Adjustment

132 The Commission Staff recommends that $71,000 be removed from pro forma power costs filed by the Company in its case-in-chief in order to reflect the fact that the Fuel Cell project does not provide benefits to electricity ratepayers. The Company accepted the Staff adjustment on rebuttal.

Commission Discussion and Decision

133 The Commission approves the $71,000 (system) and $48,000 (Washington jurisdiction) downward adjustment to pro forma power supply costs.

vi. Adjustments Related to the Company's Dispatch Model and Variability in Hydropower Conditions and Revenues from Market Transactions (1C)

134 These adjustments involve four related issues:

(1) The water year issue for which we have a Stipulation between the Company and Staff.

(2) Commission Staff's and Public Counsel's proposed Dispatch Credit.

(3) Commission Staff and ICNU's proposed imputation of market trade net revenues.

(4) The request for a Power Cost Adjustment Mechanism.

28C

Commission Discussion and Decision

135 We will address these issues in combination, rather than individually. They are closely related because they involve the Company's power supply model, and because they require balancing the risks faced by the Company and the risks faced by the customers.

136 The Company and Staff appear to agree that Avista's dispatch model is archaic and insufficient to examine operational and market issues on less than a monthly time scale. Avista also argues that the dispatch model is calibrated to power costs that are too low.

137 Commission Staff has suggested a power case to deal with some of these issues. *Commission Staff Brief, p. 5.* ICNU also identifies a power case as an the appropriate venue for consideration of some of these issues. *ICNU Brief, p. 15, footnote 3.*

138 Given that the record before us is weakened by the short-comings of the currently available power supply model data, the Commission approves power supply costs in this case only on a temporary basis. Avista should file a power cost case no later than December 1, 2001, in which it provides an improved dispatch model and more accurate power costs. Of the rates approved n this order, $8,664,576 (which is the amount of the Pro Forma Power Supply Adjustment grossed up to a revenue requirement amount) is a temporary amount that will expire on November 30, 2002, unless extended or modified by Commission order. We expect that the rates resulting from Avista's power cost filing will be set by an order entered on or before October 31, 2002, and that a compliance filing setting a new level of rates will be effective before November 30, 2002. To improve the quality of evidence upon which typical power supply costs can be established and to enable examination of the appropriate manner for sharing risks are shared between the Company and its ratepayers, the December 1, 2001 filing must include:

139 (1) Use of a more detailed dispatch model, which the Company indicates in this record it intends to implement. This model should capture the dispatch flexibility the Commission Staff seeks to estimate with its dispatch adjustment. Updating data inputs to the model should also better reflect changes that have occurred in the power market in recent months.

140 (2) Use of a 40-year water record. An alternative study may also be presented if Avista decides that a 40-year record is not appropriate. If a water record other than the 40-year record is prepared, the Company must demonstrate why use of that record is superior to use of a 40-year record.

141 (3) Results of the Company's request for proposals (RFP) concerning power resources (i.e., RFP approved in Docket No. UE-001081) and a clear description of the Company's resource plans, including plans to replace Centralia generation on a long-term basis.

142 Additionally, this new docket may be an appropriate forum to present other issues and alternatives including:

143 (4) A power cost adjustment mechanism, or a performance based approach to rate making, that balances the benefits and risks faced by the Company and its ratepayers associated with hydro variability and market transactions. If a power cost adjustment mechanism is advanced, it must meet the criteria previously established by the Commission.

144 (5) Rate recovery, if the Company proposes any, concerning the balance in the accounts approved by the Commissions order in Docket No. UE-000972 relating to extraordinary power costs.

145 We now turn to the four separate issues as they are illuminated by this record.

1. Water Record

146 The Company originally proposed use of a 60-year water record for use in its power dispatch model. According to the Company, this record provided an accurate representation of average water conditions affecting its hydroelectric projects.[3] Commission Staff objected to the use of the 60-year record, pointing to Commission

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[3] Although this was a change from the method most recently accepted or authorized for the company, Avista failed to present a work paper demonstrating how the adjustment would be calculated under the methodology previously accepted by the Commission, and a brief narrative describing the change as is required by WAC 480-09-330(2)(b).

precedent for use of a 40-year rolling average record. Based on its recommended 40-year record, the Staff proposed a reduction to normalized power expenses of $5.9 million on a system basis.

147 Ultimately, the Company and Commission Staff reached an agreement to adjust power expenses downward by $2.95 million on a system basis, or $1,976,000 for the Washington jurisdiction. This agreement was memorialized in a stipulation filed with and accepted by the Commission and included as Ex. 740 in this record.

148 In addition to establishing an agreed-upon adjustment to revenue requirement, the parties stipulate with respect to use of water records as follows:

> For purposes of this proceeding only, Staff and Avista stipulate to the continued use of the 40-year average methodology for the purpose of normalizing hydroelectric generation for ratemaking purposes, as previously adopted by the Commission in its Third Supplemental Order, dated April 4, 1986, in Cause No. U-85-36.
>
> In any future proceeding, if the Company chooses to propose any modification to the continued use of the 40-year rolling average methodology, the Company agrees to provide in its direct filing full documentation supporting its proposed change in methodology.

Ex. 740.

149 The Commissions accepts and approves this Stipulation of the Parties.

2. Adjustment to Reflect Dispatch Flexibility

150 The Company's power dispatch model is not capable of modeling generation dispatch[4] and related off-system sales and purchases of energy on a time resolution of less than one month. In other words, management strategies to change dispatch or

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[4] "Dispatch" is the way a utility, at any given moment and over time, matches its load (demand) with its resources (supply), including buying or selling generation as the load demands or allows. Depending on its sophistication, a dispatch model can analyze these dynamics on hourly, daily, or monthly basis

resources during a day, or during a month, in order to maximize revenue or minimize net costs cannot be evaluated using the existing model because it only produces monthly average figures. *T-540, p. 30, ll. 3-12.* Commission Staff and the Company agree that the appropriate way to capture optimal use of the Company's resources to minimize net costs is to use an hourly resolution dispatch model. *T-540, p. 31, ll. 14-16; T-203, p. 53, ll. 15-17.* The Company has plans to implement such a model and has, even in this proceeding, produced some analysis based on this kind of modeling applied to its generation resources on the Clark Fork system. *Ex. 88.*

151 Commission Staff originally proposed a downward adjustment to normalized power expenses of $1.6 million (system basis) to represent the value of dispatch flexibility available to the Company, but not captured in the simple monthly-average dispatch model. This estimate was derived by assuming that 50 percent of low-load-hour sales volumes could be moved into high-load-hour periods and 50 percent of high-load-hour purchases could be shifted to low-load-hour periods, and that a price differential of 4.4 mills/kWh exists between high and low load-hour market prices. *T-540, p. 33, ll. 1-9.*

152 The Company objects to Commission Staff's recommended adjustment as unreasonable. According to the Company, if Staff's adjustment is made to the dispatch model, its output produces estimated average power costs that are well below market levels. *T-203, p. 51, ll. 1-26.* Avista argues that the dispatch model, calibrated with its initial market prices and run without the Staff adjustment, still produces estimated average power costs that are well below the market.[5]

153 Commission Staff subsequently revised its recommendation to be a downward adjustment of $4.5 million on a system basis. Staff abandoned its earlier 50/50 analysis and increased the size of its downward adjustment to reflect evidence placed in the record by Avista that estimates the value of flexible dispatch in the Clark fork system. *Staff Brief, p. 65; Ex. 88.*

154 Public Counsel also recommends that normalized power costs be adjusted downward to reflect the value of dispatch flexibility not captured in the dispatch model. Public Counsel cites the same evidence produced by Avista to support the re-licensing of the

[5] Commission Staff argues that if Avista believes its power cost inputs to the model are too low, then the remedy is to file a new case with updated power costs.

Clark Fork projects and recommends a downward adjustment of $6.5 million on a system basis. *Public Counsel Brief, p. 48.*

Commission Discussion and Decision

155 The Company's dispatch model is inadequate to estimate the value of flexible dispatch on a system the Company itself agrees has such value. Staff attempts to estimate the value of dispatch flexibility, but is hampered by a paucity of reliable data. Staff's effort is noted, but we find the resulting estimate too assumption-laden to rise to the level of "fact." The study subsequently produced by Avista witness Thomas Dukich to support the Clark Fork re-licensing is a detailed and thorough one and uses the right kind of model. Unfortunately it only models the Clark Fork; it doesn't integrate operation of the Clark Fork with the rest of the Company's resources. Public Counsel argues that this means the values it produces are conservative, since the Company has other hydro resources. Flexibility of resources, however, may or may not be complementary. All of this leads the Commission to conclude that the proposed adjustments are not sufficiently reliable to support a known and measurable adjustment. We will not, therefore, approve the adjustments to pro forma power supply costs recommended by Staff and Public Counsel to reflect dispatch flexibility.

156 However, application of a more sophisticated, hourly model to the entire system would yield defensible estimates. The Commission has thus determined to implement the results of this proceeding as temporary rates, and to require Avista to implement a more sophisticated model and file a new power case.

3. Revenue from Market Transactions (1C)

157 Commission Staff and ICNU represent that Avista engages in a significant amount of energy trading activity that is not reflected in normalized power expenses. The Company has excluded the profits (and losses) from these transactions, arguing that they are too risky to include in retail rate making. *T-203, p. 22, ll. 6-12.* The Company has also excluded overhead costs of these transactions of $305,880 (Washington jurisdiction). *Id., ll. 11.*

158 Commission Staff represents that approximately $11.8 million in net revenues from this wholesale trading activity is not included in the Company's proposed pro forma

power expenses. Staff acknowledges that such trading activity is risky, but Staff argues that the transactions Avista proposes to exclude from ratemaking have not been demonstrated to be especially risky, and that all appear to fall within the scope of the Company's Resource Optimization Risk Policy. Staff claims that many of the transactions documented by the Company to fall in the category of "too risky" aren't fundamentally different than buy/sell transactions it has included as longer-term contracts.

159 Commission Staff recommends that based on its analysis of Company trading records, $5.15 million in net revenues ($3.45 million WA jurisdiction) is a reasonable amount to expect Avista to earn from these transactions, and proposes that this level of revenue be deducted from net pro forma power expenses. Staff witness Alan Buckley arrived at this number by comparing the actual short-term purchases and sales for 1996 through 1999 with the results of the dispatch model (incorporating Staff's adjustments to that model). This comparison yielded an average annual profit of approximately $10 million. The lowest annual amount across these 4 years was $5.15 million. Mr. Buckley argues that absent a showing by the Company that these transactions are truly risky, this lowest value represents a conservative and reasonable target for resource optimization profits to be reflected in rates. Staff objects to the Company's arguments that market transaction activities are "speculative in nature, [and] are not related to the operation of the Company's system resources or in serving retail load." *T-203, p. 22.* According to Staff,

> . . . what Avista has actually done is simply to remove all revenues associated with <u>any</u> transaction that does not fall out of its already deficient Dispatch Model. To assume, as Avista does, that the normalized sales and purchase amounts from the model represent the total utilization of Company resources is clearly erroneous.

Staff Brief, p. 71, emphasis in the original.

160 The Company objects to Commission Staff's analysis, arguing that it assumes that the dispatch model output of short-term sales and short-term purchases for a single year can be used as a base case against which to apply trading records for each of the years 1996 through 1999. The Company argues that this analysis can only produce errors, because the actual conditions that affected the Company's power system and the wholesale market were not the same as those assumed in producing dispatch model

output to estimate normalized power expenses. To provide an example of the nature of this analytic flaw, the Company demonstrates that simply changing the dispatch model output to represent 1997 actual hydro-generation leads to a net loss of $2.6 million under Staff's estimation method, rather than a net profit.

161 For its part, ICNU represents that Avista made a profit of $6.9 million during the test year on a system basis from commercial trading activity. *T-718, p. 20, ll. 23-24.* Avista made a pro forma adjustment to remove these revenues. ICNU recommends that the Washington allocation of $4.2 million be netted against normalized power expenses in order to reflect that profits ". . . are based on opportunities developed by the utility." *ICNU Brief, p. 25.* ICNU offers that if the Commission does not adopt this proposed adjustment, it should deduct the overhead costs of these transactions (as the Company has done) as well as the $279,280 in FERC fees associated with this trading activity, as was done in the recent Idaho proceeding. *T-718, p. 22, ll.11-12.*

162 The Company objects to ICNU's analysis as one that "cherry picked" a single year and, at the same time, ignored all of the transaction costs associated with this trading.

Commission Discussion and Decision

163 This adjustment, like the Dispatch Credit, relies on estimates—in this instance the adjustment relies on estimates of the typical level of net revenues to be expected from trading activity. Avista has made a pro forma adjustment which reduces to zero the profit of $6.9 million that it earned in the test year from commercial trading activity.

164 Determining a normalized level of profits from commercial trading activity, however, is again hampered by a lack of reliable data. Avista's demonstration of the wide variability in outcome using the Staff's method and 1997 hydro generation is telling.

165 The Commission has determined that this issue, like the Dispatch Credit, should be taken up in a new power case with a more detailed model and updated power costs. In particular, this issue bears a relationship with the next issue—power cost adjustment mechanisms—because it affects the balance of risks borne by the Company and its Customers. Rate making adjustments that impute net revenues that may or may not materialize impose risks and a related performance incentive on the Company. Rate making mechanisms that make automatic adjustments to rates for water or other cost factors impose a risk on customers. If we are to depart from our

traditional rate making based on known and measurable costs and historical test years, new mechanisms must have a reasonable expectation of balance between risks imposed on the Company and those imposed on the customers. That balance must reflect the relative positions of the Company and its customers to respond, manage, or mitigate the risks they bear.

166 The Commission is persuaded by ICNU that transaction fees associated with the Company's trading activity properly include the FERC fees ICNU has identified. We will deduct $279,280 in FERC fees, as recommended by ICNU, as well as the $305,880 calculated by the company as overhead costs of these transactions. The total is $585,160, representing a NOI reduction of $380,000 on Table 3 "Commercial Trading." We will otherwise allow the Company adjustment to costs and revenue for trading transactions.

4. Power Cost Adjustment Mechanism

167 The Company proposed that it be allowed to implement a Power Cost Adjustment (PCA) that would result in either surcharges or rebates to rates, based on water conditions and such other factors as PURPA power costs, hydro-shape, and secondary market power costs. *T-420, p. 2, ll. 13-25*. It argues that this adjustment mechanism is necessary to enhance earnings stability, in the face of volatility in hydro production caused by variation in weather and volatility in power costs related to market conditions. In response to objections raised by Commission Staff, Public Counsel, and ICNU, the Company modified its proposal on rebuttal to include only variation in hydro production and short-term market rates for power. *T-426, p. 15, ll. 1-24.* The Company represents that with the modifications it made on rebuttal, the mechanism addresses all of the concerns and deficiencies raised by the parties. According to the Company, all the issues have now been addressed in this proceeding and ". . . There is accordingly, no need for the matter to be put off to another proceeding, through a so-called 'collaborative' process." If the Commission is not yet satisfied, the Company proposes that the mechanism be adopted on an interim 3-year trial basis. *Company Brief, pp. 41-42.*

168 Commission Staff opposes the Company's proposal. Staff recommends that the proposed mechanism not be approved as filed. Instead, it recommends that the Company initiate a process to develop a power cost adjustment mechanism that

includes customer input, and that explicitly addresses the conditions that the Commission has in the past set out for Avista to meet. *T-540, p. 44, ll. 6-16.*

169 The conditions previously set out by the Commission are:

170 (1) Ratepayers should receive the benefit of a cost of capital reduction for a PCA to be approved.

171 (2) A power cost adjustment mechanism should be linked to those factors that are weather related;

172 (3) A power cost adjustment mechanism should be a short-run accounting procedure that reflects changes in short-run cost affected by unusual weather.

In re the Washington Water Power Company's Petition for an Accounting Order Permitting Implementation of a Power Cost Adjustment, Docket No. U-88-2363-P, First Supplemental Order Denying Petition (September 1989).

173 Mr. Buckley, for Staff, testified that the mechanism proposed by the Company does not meet these conditions because (1) it reduces risk to the Company, but provides for no benefit to the consumer in reduced cost of capital; and (2) it includes changes in market prices that are not related to weather.

174 According to Commission Staff, while the modified proposal removes PURPA costs and Company generation costs, it links the impact of changes in hydro production to short-term market costs. This, Staff argues, exposes customers to market risk that could and should be moderated through optimization of the Company's resources. Staff represents that both the original and the modified versions of the mechanism make adjustments based on the dollar amount of sales and purchases, and this means that ". . . even if hydro-generation remains the same, any changes in prices (market index prices under the Company's proposal compared to prices from the Simple Dispatch Model) are reflected in the PCA." *Staff Brief, p. 38.* Finally, Staff objects that the mechanism, even in its modified form, contains no incentives for least cost acquisition of power, because it allows changes in market-index prices to be simply passed through to customers. *Id., p. 40.*

175 Public Counsel also opposes the power cost adjustment mechanism as proposed and as modified. He maintains that the original proposal is largely similar to one rejected by the Commission in Cause U-88-2363-P concerning PCA. According to Mr. Lazar, the mechanism proposed in that proceeding was flawed in at least five ways:

176 (1) It was asymmetrical; there would be more surcharges than credits.

177 (2) It would lead to random variations in rates.

178 (3) It would create incentives for inefficiency in managing power supply.

179 (4) If would permit double recovery of fixed power supply costs.

180 (5) A uniform percentage surcharge is not appropriate.

181 He argues that the proposal in this proceeding suffers from the same deficiencies. He notes that the Commission established criteria for a PCA in that proceeding, and argues that the current proposal does not meet those criteria.

182 In response to the Company's revised proposal, Public Counsel represents that in addition to the deficiencies noted by Commission Staff: there is no justification to tie market prices exclusively to the mid-Columbia index; the mechanism may be too sensitive to changes in hydro-conditions; and the mechanism may be subject to "gaming." *Public Counsel Brief, pp. 39-41.* If the Commission is to implement the mechanism, Public Counsel recommends that the rate of return should be lowered significantly from that proposed by Public Counsel witness Hill. *Id., p. 41.*

183 ICNU also recommends rejection of the proposed power cost adjustment mechanism in both its original and revised forms. *ICNU Brief, p. 4.* In addition to the deficiencies identified by Commission Staff and Public Counsel, ICNU argues that the proposed mechanism is not in the public interest because "... it would discourage the Company from filing periodic rate cases ... [and] it is not consistent with changes underway in the electric utility industry." *Id., p. 4.* On this latter point, ICNU represents that PCAs are being replaced around the country with more innovative, performance-based regulation.

Commission Discussion and Decision

184 Commission Staff, Public Counsel, and ICNU have raised significant concerns about the original and modified PCA proposals. In particular, Staff's point that the mechanism corrects for changes in revenue (which are not necessarily related to weather), rather than changes in physical generation (which is related to weather), is a compelling one. Linkage of the adjustment to changes in both the value of hydro-generation and variation in market prices at the mid-Columbia could cause customers to face directly the risks of both weather and lack of regional (even California) system capacity. The latter may or may not be correlated with hydro system performance.

185 The PCA proposed by Avista is not appropriate. The parties may explore the issue further in collaborative meetings, or in the 2001 power supply proceeding. The Commission is willing to explore proposals that provide greater incentives than the traditional rate base/rate of return paradigm that we currently employ to regulate Avista.[6] As we have already noted, such proposals must include an equitable balancing of risk between ratepayers and shareholders. Mechanisms that simply shift risk from shareholders to ratepayers without compensating benefits do not meet this objective.

vii. Summary of Pro Forma Power Adjustments

186 The Commission approves pro forma adjustments to test year power costs of $12,355,000 on a system basis, and $8,276,000 on a Washington jurisdiction basis. The approved adjustment to net operating income is $5,380,000 shown under the label "Pro Forma Power Supply" in Table 3. This increase is approved on a temporary basis to expire November 30, 2002 unless extended by Commission order. Avista is directed to file a revised power supply case documenting net power supply costs no later than December 1, 2001.

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[6] The current regulatory model has acted as a form of performance-based regulation, in that it has allowed Avista, through various efficiencies, to avoid seeking an increase in general rates since July 1, 1990.

b. Centralia Replacement Power Contract (2)

187 Avista entered into a contract with the owner of the Centralia power plant, TECWA, to purchase power to replace the share of Centralia formerly owned by the Company and used to meet load obligations. The contract was signed on October 25, 1999, with service to commence after the date the sale of the Centralia plant to TECWA closed. The power contract provides for delivery of a 200 MW flat power product for the years 2000 through 2003, excepting the months of April through June each year.

188 The Company proposes to include that contract in its net power purchase expenses and to remove from the test year the operating costs and rate base associated with its former ownership share of Centralia. According to Avista it has shown that its TECWA contract is prudent because the contract meets the utility's immediate need, was made contingent on the closing date of the sale, allows for dispatch during the April through June spring run-off, and was priced lower than other products in the marketplace. Moreover, it argues that it did perform an economic analysis to compare alternative products and prices to meet the power need occasioned by the sale of the Centralia plant. *Ex. C-214.* According to Avista, Commission Staff has not taken issue with the price it paid for power in the contract, or its need for the power purchased.

189 Commission Staff opposes including the replacement power contract in normalized power expenses and proposes instead to leave the costs of Centralia incurred in the test year in rates. Staff argues that the power contract Avista has secured with TECWA has not been proven by the Company to be necessary, prudent, or least cost. According to Staff, ratepayers should be held harmless for the contract until the Company has demonstrated it is needed and that its costs are justified.

190 Public Counsel also opposes including the TECWA power contract in rates at this time. According to Public Counsel, the contract has not been demonstrated to be needed or prudent. He argues that in the *Centralia* proceeding, Avista maintained that replacement power would cost less than Centralia power for the first decade following the sale. Now, according to Public Counsel, the Company indicates that replacement power will cost more than ownership and operation of Centralia. He argues that the detailed analysis and comparisons prepared by Avista to evaluate the TECWA contract show that Avista knew the cost of replacement power would exceed Centralia costs as early as November of 1999, yet it did not provide this information

to the record in the *Centralia* docket. Public Counsel recommends that the Company should be held to its word in the *Centralia* proceeding, and any increase in the cost of power resulting from the Centralia sale should be rejected. He recommends that the replacement power cost for Centralia should be considered in the next general rate case. *Public Counsel Brief, p. 42.*

191 ICNU also objects to the inclusion of the cost for replacement power in rates. ICNU joins with Commission Staff and Public Counsel to argue that the Company has failed to demonstrate the prudence of the replacement resource. Centralia has a high availability factor throughout the year, and could be displaced if market prices are less than incremental generating costs. The replacement contract cannot be economically displaced in this way, which means the Company will incur higher power supply costs during favorable market conditions. Mr. Schoenbeck estimates a displacement value of almost $10 million, when power could be supplied more cheaply by the market than by the TECWA contract. ICNU recommends that the Commission reject inclusion of the contract costs in rates "... until the Company submits a plan for replacing Centralia on a permanent basis." *ICNU Brief, p. 24.* Until then, ICNU finds acceptable Staff's proposal to hold Centralia costs at test year levels. Alternatively, ICNU's own proposal is "... that interim rates be based on the cost of market purchases using the results of the Company's power supply model fitted in this case." *Id., 25.*

Commission Discussion and Decision

192 It is clear that the Centralia replacement power contract is not intended to be a long-term solution. It is a short-term contract. The Company has begun a bid process to acquire longer-term resources. Given the documentation in the record of the Company's decision process, and given that Commission Staff does not object to either the price or the need, the prudence of this short-term resource has been adequately established.

193 ICNU's proposal to impute several hundred MW of power purchase costs from the Company's power supply model is not appropriate, given the shortcomings known to exist in that model, including the model's apparent deficiencies in calibrating and the fact that it may be poorly calibrated for current market conditions.

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194 Public Counsel's objection to the information provided in the *Centralia* proceeding is that the market cost of power was increasing during the *Centralia* proceeding, and that Avista did not update its analyses to reflect what it knew about these market prices. Further, Public Counsel argues that the adjustments made to the Company's power supply model to reflect the removal of Centralia indicate that this change had system effects on other resources and costs, and that this analysis was never presented in the *Centralia* proceeding. Finally, Public Counsel represents that the requested increase of $4.1 million is evidence that the Company misrepresented the impact sale of the plant would have on ratepayers.

195 As we noted in the Fourth Supplemental Order in *Centralia*[7], the test year level of costs for *Centralia* did not include recovery of the capital and other costs associated with scrubbers. While these costs had not been incurred by 1998, it was clear that they would have to be incurred to keep the plant running. Therefore, the appropriate comparisons made in *Centralia* were based on market forecasts versus the cost of the plant *with* scrubbers. The Company's requested increase in revenue requirement reflects the difference between actual market (i.e., the TECWA contract) and Centralia costs before scrubbers were installed (i.e., the cost of scrubbers not yet installed is obviously not yet included in the cost of Centralia on Avista's books). Even though market prices were increasing during late 1999 and early 2000, Avista's Exhibit C-214 demonstrates clearly that annual average costs for the TECWA contract are lower than the cost of Centralia (with scrubbers) over the entire 2000 to 2003 period. Public Counsel has not provided any analysis showing that our conclusion in *Centralia* was incorrect. Therefore, the Commission concludes that approving recovery of the cost of the Centralia replacement power contract is fully consistent with our decision in *Centralia.*

196 The Commission approves Avista's adjustment, which pro forms the known and measurable costs of the TECWA contract to the test year in replacement of the previous costs of Centralia. This represents an increase in required net operating income of $3,646,000 on a Washington basis shown under the label "Centralia Replacement Power" in Table 3.

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[7] *In re Avista Corporation, PacifiCorp and Puget Sound Energy Petitions to Sell the Centralia Plant and Related Facilities*, Docket Nos. UE-991255, UE-991262 and UE-991409.

c. Potlatch Contract (3)

197 The Company's case-in-chief proposes to include net operating income of $683,000 it receives under its Potlatch contract, in return for supplying power to Potlatch.. This figure is calculated based on the pricing provisions of that contract together with cost of secondary power derived from the Company's power supply model.

198 Commission Staff recommends an adjustment to this value based on its modifications to the output of the Company's power supply model. The Staff recommends a net operating income level of $405,000. Staff witness Mr. Parvinen states that the proper level depends on the non-firm rates developed in the pro forma power supply adjustment. *T-608, pp. 12, ll. 1-5.* On Brief, the Staff state that this adjustment depends on the non-firm power rates approved by the Commission. *Staff Brief, p. 45.*

Commission Discussion and Decision

199 The power supply net expense adjustments related to the Company's Dispatch Model have been decided on either an individual basis in the preceding sections of our decision, or as a part of the Stipulation regarding the water record issue. *Ex. 740.* The Commission has not otherwise accepted the output of the power supply model as proposed by Staff. Therefore, we will not modify the level of net operating income for the Potlatch contract, as proposed as a pro forma adjustment by the Company. The adjustment is approved at $683,000 of net operating income and is shown under the label "Potlatch" in Table 3.

d. Injuries and Damages Account (4)

200 Avista has included the costs associated with the settlement of litigation associated with a 1991 Firestorm, including all legal fees, and all costs associated with a 1996 Icestorm. The Company proposes amortizing the Firestorm costs over six years, and using its share of the gain from the sale of Centralia to offset the Icestorm Costs.

201 Commission Staff argues that the legal fees incurred for the 1991 Firestorm litigation ($232,000 for each year of the six-year amortization period) should not be allowed in rates. Test year legal fees, not including Firestorm litigation, are $2.6 million system wide. This is the highest amount expended at any time between 1989 and 1999. Staff does not contest the settlement amount itself, but rather contest only the litigation

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costs incurred in reaching the settlement. Staff dismisses the contention of Avista that not allowing Firestorm legal fees creates a perverse incentive for the Company to agree to a settlement (covered in rates) to keep legal fees down (not covered in rates).

202 Commission Staff also challenges Avista's proposal to offset the 1996 Icestorm costs with its share of the gain from the sale of the Centralia coal plant. Staff considers this an out-of-period, abnormal, non-recurring event. Staff calls the attempt to recover Icestorm costs retroactive ratemaking, and observes that Avista seemingly made it clear that it would not seek cost recovery. Avista replies that its press statements at the time indicated only that it would not seek immediate recovery by a surcharge. *Avista Brief, p. 81.*

203 Public Counsel adopts the Commission Staff position for both the Firestorm and Icestorm costs.

204 ICNU considers all of the Firestorm costs a non-recurring, prior-period event that should not be included in rates.

Commission Discussion and Decision

205 The purpose of a test year, and of restating and pro forma adjustments to test year data is to develop a "normal" level of expenses that is expected to match the Company's expenses in the rate year. Once set, levels of expense vary, and are expected to vary, from those established. If expenses reach a level where the Company cannot earn a reasonable return, then the Company may file for a rate increase.

206 Companies also have an opportunity to seek an accounting order from the Commission if they want permission to amortize a cost for the purpose of regulatory accounting, and an opportunity to seek recovery in a future rate case. This practice gives notice to the Commission and parties who may wish to examine, in a timely manner, the Company's earnings and other circumstances.

207 Both the 1991 Firestorm and the 1996 Icestorm occurred before the test year. Both are unusual events that appear to be "non-recurring," i.e., there is no reason to expect that they will happen again in the rate year. Avista did not seek timely accounting orders for either event. Nor did Avista provide any information regarding its earnings in 1991 and 1996, or regarding any financial windfalls it may have received in those

years. Without information regarding Avista's financial circumstances and potential offsets in the years in which these costs were incurred, or of any offsetting costs, the Commission has no basis for concluding that recovery of these costs is appropriate. We will follow the general rule against including out-of-period, non-recurring expenses in rates. The Commission will not include costs of either the 1991 Firestorm or the 1996 Icestorm in Avista's rates. We do not approve the $(1,514,000) adjustment to net operating income in the Injuries and Damages account prepared by the Company. Nor do we approve the $(32,000) adjustment to net operating income in the Injuries and Damages account prepared by Staff and Public Counsel.

e. Nez Perce Settlement Idaho Direct Assignment (5)

208 Avista was sued by the Nez Perce tribe for claimed damages caused by prior operations of the Company. The damages sought included claims for tribal taxes and rights-of-way that relate only to the Company's operations in Idaho. The lawsuit was settled, and Avista proposes to include an allocated portion of the Nez Perce Settlement costs in Washington rates. This cost represents a reduction in net operating income of $380,000.

209 Avista claims the settlement was a "black box" settlement that does not purport to assign dollar amounts to specific contested issues. Instead, Avista that contends the rights-of-way and tax issues were simply eliminated by a negotiation process that focused primarily on alleged damages caused by prior operations of the Company.

210 Commission Staff agrees that it is appropriate to include certain costs of the Nez Perce settlement in Washington rates. Staff argues, however, that costs associated with a portion of the settlement pertaining to Idaho operations should be excluded from Washington rates. Staff claims the settlement agreement clearly states that the settlement amount includes payments for rights-of-way and tribal taxes, and claims that those specific items are solely the responsibility of Idaho customers. Staff recommends that a reduction to net operating income of $341,000 be approved.

211 Public Counsel supports the Commission Staff position. Public Counsel argues that the Company admits that all issues were resolved in the settlement agreement. Therefore, the Idaho issues were implicitly resolved, and costs associated with those issues should now be directly assigned to Idaho ratepayers.

Commission Discussion and Decision

212 The Commission agrees that certain costs of the Nez Perce settlement should be included in rates. The settlement agreement is in the record. *Ex 239.* It is also clear, however, that the agreement resolves certain tax and right-of-way issues that exist only in Idaho. The Commission agrees that an allocated portion of costs to cover these issues should be directly assigned to the Idaho jurisdiction. The Commission approves the Commission Staff adjustment, which removes $60,000 from the Nez Perce costs. *Ex. 578*; $ 525,000 of Nez Perce costs should be included in Avista's Washington electric rates. This represents a reduction to net operating income of $341,000 and is listed under "Nez Perce" on Table 3.

f. Staff Miscellaneous Adjustments (6)

213 Avista is proposing to include expenses associated with political advertising, promotional advertising, and certain subsidiary expenses. The Commission Staff would remove these costs.

i. Lobbying activities and Political advertising

214 The Commission Staff sponsors an adjustment that would remove the costs of certain corporate memberships, arguing that the organizations use the funds for lobbying. Staff cites WAC 480-090-032 and 480-100-032, which expressly forbid political advertising and lobbying expenses in rates. Staff asserts that the organizations to which Avista has paid membership dues do engage in lobbying activities and that some exist largely for that purpose. The list of memberships whose costs Staff questions are found in Exhibit 29.

215 Avista states that the corporate memberships are with organizations that conduct no lobbying and, therefore, membership costs should not be disallowed.

216 Public Counsel supports the Commission Staff adjustment but argues that the Staff adjustment is too conservative. Public Counsel chastises Staff for not removing expenses for promotional bill inserts and lobbying activities of certain Company officials.

Commission Discussion and Decision

217 The Commission has examined the list of organizations in Exhibit 29 Attachment B, and weighed the description of each organization's activities against the criteria given in WAC 480-090-032 and 480-100-032, the degree to which the organization operates in other jurisdictions, whether dues to the organization should be considered a charitable contribution, and the degree to which the organization's activities benefit subsidiary operations and ratepayers. As a result, the Commission has determined that dues for organizations numbered 1, 2, 3, 4, 8, 15, 16, 18, 19, 21, 22, 23, and 24 should be allowed; dues for organizations numbered 5, 7, 9, 10, 11, 12, 13, 14, 17, 20, and 25 should not be allowed; and 50 percent of the dues for item 6 should be allowed. The result reduces Washington test year operating expenses by $37,861 for electric, and $8,548 for gas.

218 The Commission shares Public Counsel's concern that the regulated utility may be subsidizing promotional bill inserts. It is unfair to competitors for Avista ratepayers to subsidize Avista's competitive affiliates. Avista's will be required to account for the value to affiliates of bill inserts in its next general rate proceeding.

ii. Redmond Tribute film

219 Avista had a film produced honoring its former Chairman of the Board and Chief Executive Officer, Paul Redmond, upon his retirement. Avista considers the film important for employee morale and an appropriate expense for any company to honor a long time employee of the stature of Paul Redmond.

220 Commission Staff proposes to remove the expenses associated with the Paul Redmond tribute film. Staff argues that these expenses are not related to utility operations and provide no benefits to ratepayers.

Commission Discussion and Decision

221 We agree with Commission Staff that the tribute film costs are not related to utility operations, and that utility customers should not pay them. We accept Mr. Schooley's reduction of test year expenses by $26,527 for Washington electric, and $6,670 for Washington gas, as calculated in Exhibit 600.

iii. CEO Search Costs

222 Avista incurred CEO search costs in 1998. All of these costs were assigned to the regulated utility. Avista asserts that "with or without subsidiaries, the Company would have gone through the same rigorous, national search for a new CEO." If the Commission decides that a portion of the costs should be allocated to subsidiaries, Avista argues that a 15.22 percent allocation would be appropriate. *Avista Brief p. 89, Ex. 268, p. 21.* Commission Staff argues that assigning all costs to the regulated utility is unreasonable, as is the premise that these costs would have been incurred even without subsidiaries. Staff proposes to allocate the CEO search costs in the same manner as other regulated/non-regulated operations.

Commission Discussion and Decision

223 The Commission rejects the Company's proposal that CEO search costs be the sole responsibility of ratepayers. The CEO has a company-wide responsibility. Consequently, CEO search costs are appropriately allocated between regulated and non-regulated operations in the same manner as other officer costs. We accept Staff's allocation of 47.7 percent of total CEO search cost ($408,544) to subsidiaries, and the consequent reduction to Washington test year expense of $100,681 for electric and $25,314 for gas. *Ex. 600.*

iv. Toronto Dominion Fees

224 Avista recorded expenses paid to Toronto Dominion, a financial institution, for maintenance of short-term- debt lines of credit. In its rebuttal testimony, the Company claims these amounts are not factored into short-term rates in the cost of capital calculation, and continues to seek their recovery as a separate adjustment.

225 Commission Staff asserts that the payments to Toronto Dominion duplicate amounts already included in the cost-of-money calculation. According to Staff, the line item expense is also incorporated into the cost of money and increases the cost of debt.

226 Public Counsel supports the Staff-proposed miscellaneous adjustment, referring to it as a standard ratemaking adjustment. Neither Commission Staff nor Public Counsel addresses this adjustment in their post-hearing briefs.

Commission Discussion and Decision

227 The Toronto Dominion Bank fees are reasonable and should be allowed in test year expenses. We don't accept Staff's proposal to remove $24,000 from electric, and $6,000 from gas, test year expenses. These fees are not interest expenses, but rather appear to be similar to periodic bank administrative fees for maintaining the line-of-credit accounts. The fee may vary slightly with the amount borrowed, but must be paid, even if little or no balance is outstanding.

228 Accepting Staff's miscellaneous adjustments in part, as discussed above, increases Avista's Washington net operating income by $292,000 for electric operations, and $162,000 for gas.

g. Y2K Costs and Corporate Name Change (7)

229 Included in this section are discussion and decisions regarding Commission Staff's two "Miscellaneous Adjustments": Y2K Expense and Name Change Cost and, combined with Name Change Costs, Public Counsel's proposal to charge Avista's subsidiaries for use of the "Avista" name.

i. Y2K Expense Adjustment

230 Avista proposes to amortize its Y2K costs incurred in test year 1998 over a five-year period. System-wide this amounts to $1,651,000 ($777,000 for Washington electric and $197,000 for Washington gas). The Company does not seek to recover all Y2K expenses; it seeks no recovery of Y2K expenses incurred in 1997 and 1999. Avista claims the scope of its Y2K effort was greater than just checking computer hardware and software. This effort addressed issues such as energy suppliers' ability to deliver, emergency services preparedness, external and internal communications systems reliability, security at physical facilities, and emergency power distribution capabilities. Avista claims the Y2K expenses were prudently incurred, and that not responding to the Y2K risk would have been derelict.

231 Commission Staff proposes to eliminate all Y2K expenses. Staff asserts that the expenses are non-recurring and should be removed to arrive at a representative ongoing cost of operations. Staff discounts the Company's claim of "new value" being added by pointing out that it is the Company's obligation to ensure that its

systems continue to function properly. Staff argues that an extraordinary expense of this nature should not be embedded into rates.

232 Public Counsel supports the Commission Staff position on Y2K expenses, agreeing that the costs are non-recurring and should not be reflected in future rates.

233 ICNU contends the Y2K expenses are non-recurring and must be excluded from the test year. ICNU argues that these costs will obviously not occur again in the life of the proposed rates.

Commission Discussion and Decision

234 Avista is seeking to recover and normalize over five years extraordinary expenses that were incurred in the test year. The Commission agrees that the expenses were prudently incurred, and approves the adjustment. While we agree with Commission Staff that it is the Company's obligation to ensure that its systems continue to function properly, we disagree with Staff's conclusion that costs prudently spent to meet that goal should not be recovered. Avista is seeking recovery only of the test year level of expense, and is proposing to normalize that expense over five years. Funds spent to upgrade Avista's computer systems, and to test the emergency preparedness of its system, benefit ratepayers beyond the Y2K "event." Test year costs that were prudently spent for those purposes, as normalized by Avista, should be included as an expense in rates. This adjustment increases net operating income by $404,000 for electric operations and $102,550 for gas operations.

ii. Name Change Costs Adjustment/Corporate Name Use Fee (7A)

235 Avista seeks to amortize its 1998 name change costs over five years. The system-wide expense is $1,123,000 ($529,000 for Washington electric and $133,000 for Washington gas). In early 1999 the name "The Washington Water Power Company" was retired, and the Avista corporate name was transferred from an internal holding company to the parent company (formerly Washington Water Power). Avista claims the name "Washington Water Power" caused confusion among investors, analysts, and third-party contractors, and in national publications, and that changing the name to "Avista" has mitigated the confusion.

236 Commission Staff proposes to remove all test period expenses associated with the name change. Staff rejects the Company's position for two reasons. First, Staff argues that this is a one-time, non-recurring event not representative of current or future utility costs. Second, Staff claims that the Company did not show any ratepayer benefits resulting from the name change. Staff points out that the Company could not support its allegation that the old name caused customer confusion. Staff contends that the Avista name creates as much confusion as it allegedly resolves.

237 Public Counsel supports Commission Staff's position and adds another adjustment. Besides removing all test period name change expenses, Public Counsel proposes that Avista Corporation should be required to reflect on its regulated books a charge for the use of the corporate name. Public Counsel claims that now that the parent utility carries the "Avista" name, the non-regulated entities of the same name should compensate the regulated operations for use of the name. The Company replies that the non-regulated subsidiaries actually acquired the name "Avista" first, so if anything, the regulated firm should arguably pay the *subsidiaries* a franchise fee. *Avista Brief, p. 87.*

238 ICNU proposes that the name change costs be excluded from the revenue requirement. ICNU likens the name change to an initial stock listing on the New York exchange. It was a one-time expense. The Commission has disallowed stock listing costs and should also do the same here. ICNU also points out that the name change has no benefit to customers.

Commission Discussion and Decision

239 The Commission agrees with Commission Staff, Public Counsel, and ICNU that the name change has no demonstrated benefit to ratepayers.[8] The Commission notes that one outcome of the name change has been customer confusion over the ownership of the Company. The public comments reflected in Exhibit 744 indicate that some customers believe that The Washington Water Power Company (WWP) was bought

[8] "An expense may be prudent but not recoverable from ratepayers if it provides no benefit." *US West v. Utils. and Transp. Comm'n*, 134 Wn. 2d 74, 126, 949 P.2d 1337 (1997).

by, or merged with, another company.[9] The Staff adjustment to remove these costs is approved, revising net operating income by $344,000 for electric operations and $86,000 for gas operations.

240 The Commission will not, impose a franchise fee on Avista's subsidiaries, as requested by Public Counsel. Because we imposed no costs on the ratepayers for the name change, consistency requires that no monetary benefits be awarded to them either. There is no "value" to reimburse to ratepayers if the ratepayers aren't paying for, or receiving, that value in the first place.

iii. Conclusion Y2K and Corporate Name Change Adjustment

241 In combination, these adjustments, approved by the Commission, increase net operating income by $748,000 for electric operations and $189,000 for natural gas operations.

h. Executive Compensation (8)/Team Incentive Bonus (8A)/Administrative and General Salary Adjustments (9)

242 The Commission will discuss in this section the Company's proposal to increase expense levels for executive compensation, Commission Staff's proposal to remove the costs of certain test year team incentives and Public Counsel's proposal to lower administrative and general salaries.

243 Though Avista proposes a pro forma adjustment to remove $522,724 of officer expenses, $417,021 from Washington electric operations, and $105,703 from Washington gas operations, Commission Staff recommends removing more than twice this much. The Company and Staff differ on several compensation issues, including: a) the overall level of adjustment to officer salaries; b) CEO base salary; c) signing bonuses and restricted stocks; d) pro forma increase to officers' salaries; e) allocation of officers' salaries between regulated and non-regulated operations; and f) team incentive bonuses. In addition, Public Counsel proposes an administrative and general salary adjustment. A related adjustment, relocation expenses, follows.

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[9] Unfortunately, these customers also complain that this "new" company is providing poorer service than was provided by WWP.

i. Allocation of Officers' Salaries Between Regulated and Non-regulated Operations

244 Avista's proposed pro forma adjustment rests on the allocation of officer compensation to subsidiaries *(Ex. 382)* based on the "informed judgment of each officer as to where that officer spends his or her time." *Avista brief, p. 73.* Following a precedent from Washington Natural Gas (WNG, *Docket No. UG-920840*), Commission Staff recommends an allocation factor based on a three-year average of revenues, employees, and non-officer wages of regulated and non-regulated operations. Using this allocation factor, Staff would allocate 52.3 percent of officer salaries to regulated operations and 47.7 percent to subsidiaries.

245 The Company argues that its method is superior because it uses informed judgment by each officer; it recognizes substantially different officer responsibilities that may evolve over time (versus Staff's formulaic approach); and it produces reasonable results, since 31 percent of officer salaries are allocated to non-regulated subsidiaries.

246 Staff recommends categorically rejecting Avista's approach in that it's a recipe for unprincipled, arbitrary salary allocation based on subjective recollection. Staff argues that Avista's "method" is not a method at all: there is no documentation or actual data to support the officers' allocation decisions, and no work papers or study to account for time spent on specific activities or subsidiaries. Avista's allocation appears inconsistent with evidence in the record. For example, Mr. Edward Turner is president of unregulated Avista Services, (Ex. 573) but allocates 100 percent of his time to the regulated company. Ex. 382. Avista CEO Tom Matthews' subsidiary allocation of 40 percent is the same as his predecessor Mr. Redmond, even though he took on new non-regulated responsibilities when Mr. Redmond left. *Staff Brief, p. 20.*

247 The Company argues that Staff proposes a formulaic and inflexible approach which does not recognize greatly different officer responsibilities for regulated and non-regulated subsidiaries. Even if a formula were to be applied, Avista claims WNG's formula has no meaningful application to Avista and produces flawed results. WNG allocated a very small amount of executive compensation to its subsidiaries (unlike Avista's allocation of $1.18 million), and its subsidiaries do not resemble Avista's. Avista's energy trading company skews the results because its many financial-only transactions show unusually high revenues. According to Avista, Staff has not adjusted for over 2,000 "third- and- fourth-tier" employees working under Penzer's

many operating subsidiaries. If the formula were corrected for what the Company views as revenue and employee count, it would result in a subsidiary allocation of only 15.2 percent, substantially less than the 31 percent charged by officers using informed judgment.

248 Commission Staff replies that the numbers used in its allocation factor are consistent with other data in the record, including the Towers Perrin study and SEC reports. *Staff Brief 18, Ex. C-401 and Exs. 5, 400, and 415.* If adjustments are made to the Company revenues and to number of employees used in the allocation, Staff claims similar adjustments should be made to the group of peer companies used to determine officer salaries, in order to compare Avista to companies with fewer revenues and employees.

Commission Discussion and Decision

249 Allocators are most appropriately used for ratemaking purposes when a reliable direct assignment of costs cannot be made. Avista has provided a direct assignment, albeit without much evidence of how that assignment was done. Our decision rests on how much weight to give to the Company's allocation judgment. Recalling that the Company bears the burden of proof, we find that Commission Staff is correct: the Company provided virtually no support in the record to validate the reliability or accuracy of the officers' "informed judgment." Given that some assignments are clearly at odds with other evidence of officer responsibilities, Avista has failed to carry its burden of proof for its direct assignment of officers' salaries.

250 We turn, then, to the allocation method proposed by Commission Staff. The "WNG" method has a sound theoretical foundation. It gauges the relative importance of regulated versus non-regulated business activity in three different dimensions: revenues, employees, and non-officer wages. It doesn't study a single point in time, but rather uses a three-year average of these factors. It uses numbers that the Company develops and publicly reports elsewhere. Although Avista's subsidiaries differ from WNG's, Commission Staff points out that any adjustments to allocation factor numbers (e.g., revenue) would suggest equivalent adjustments to other numbers (e.g., for officer compensation). The allocation derived by Staff witness Joanna Huang following the "WNG" method, which allocates 52.3 percent of officer salaries to Avista's regulated operations and 47.7 percent to non-regulated, is superior to the

allocation proposed by Avista. The Commission will use Ms. Huang's allocation of salaries. *Ex. 574.*

ii. CEO base salary

251 Mr. Matthews earns $750,000 per year as CEO of Avista. Commission Staff recommends adjusting his salary to $570,000 for rate-making purposes with an allocation to the regulated utility of $298,110. Staff's proposed salary for Mr. Matthews is above the median for the total pool of comparison companies (i.e., those with annual revenues of $1–3 billion, and those with annual revenues of $3–6 billion). *See Ex. 572.* According to Staff, the Company's analysis of executive compensation (the Towers Perrin study, *Ex. C-401*) ignores the group of smaller companies, but Avista resembles the smaller companies in many more ways (e.g., assets, number of employees, and market capitalization) than it resembles the larger group (annual revenues). Mr. Matthews' salary is high even within the $3-6 billion group.

252 Avista argues that Mr. Matthews' salary is within a range of reasonableness, as shown by the Towers Perrin study. It argues that the Company's Board of Directors should be given discretion to decide what salary is necessary to attract the sort of CEO candidate who will lead a company that is clearly repositioning itself. Commission Staff answers that Avista management is free to pay whatever it wants, but ratepayers should only pay a reasonable CEO salary, with shareholders bearing additional expense above that amount.

Commission Discussion and Decision

253 We agree with Commission Staff in principle: Avista's Board of Directors is free to pay whatever compensation it believes is necessary for a CEO with qualifications necessary to run its regulated and unregulated lines of business, but ratepayers should only pay a reasonable CEO salary for the regulated business, with shareholders bearing additional expense above that amount. Moreover, Mr. Matthew's base salary is only one component of his overall compensation, which also includes a signing bonus and restricted stock. Therefore, we discuss and decide the appropriate level of his overall compensation below.

iii. Signing Bonuses and Restricted Stocks

254 Avista's test year included signing bonuses and restricted stock to three executive officers as part of a "total compensation package" to attract and retain qualified individuals. Mr. Matthews, in particular, received a significant signing bonus of $1,000,000. *1998 Annual Report, Proxy Statement and Financial Report, Ex. 374, pp. 13, 15.* Commission Staff would remove these expenses for ratemaking purposes because Avista failed to show that these are recurring, ongoing business expenses, or that ratepayers have benefitted from these generous offerings to executives.

255 Avista argues that these elements of compensation are necessary recruitment tools. Commission Staff's own data set shows that 30 of 41 companies use stock awards, as do 19 of 29 companies in the Towers Perrin study. *Avista Brief, p. 72.* Avista's stock option grants lag behind its peer group. Executive compensation is based on the concept that top talent creates greater efficiency and productivity, which ultimately provides the best service to customers.

256 Commission Staff replies that the Company's 1998 proxy statement declares that "the primary objective in establishing compensation opportunities for executive officers is to support the Company's goal of maximizing the value of shareholders' interests." *Ex. 374, p. 10.* Avista's non-regulated operations grew from one subsidiary in 1995 to 13 in 1999; 71 percent of operating revenues in the test year came from non-regulated portions of the business. Mr. Matthews' experience with non-regulated operations was clearly a factor in Avista's decision to hire him as CEO. While 30 of 41 firms in Staff's data set use stock awards, Staff argues that the relevant question is whether the cost of these awards should be borne by ratepayers or shareholders. Staff notes that Avista has not shown that any of these companies passes through the costs of signing bonuses to regulated ratepayers. In its 1987 Northwest Natural Gas decision, the Commission held that stock option plans should be a shareholder responsibility. *Cause No. FR-86-142, June 17, 1987; 1987 Wash UTC LEXIS 84.*

257 Public Counsel proposes an Administrative & General salary adjustment in paragraph 274 with a similar effect and for similar reasons, although he also believes Staff's proposed adjustment is reasonable. Public Counsel notes that high salaries may be necessary to attract talents that shareholders desire, but skills to serve ratepayers are not so expensive. The million dollar bonus paid to Mr. Matthews is excessive and unprecedented in Washington utility regulation.

Commission Discussion and Decision

258 Since, as Avista states, its "primary objective in establishing compensation opportunities for executive officers is to support the Company's goal of maximizing the value of shareholders' interests," shareholders should be responsible for an appropriate share of the total compensation package. In deciding the degree to which compensation should be apportioned between shareholders and ratepayers, we will be guided by several factors, including: the degree to which officer skills are necessary for regulated businesses versus unregulated lines; compensation received by officers at peer companies; the overall level of officers' "total compensation package"; and the unique circumstances of each company. These factors are by no means exclusive, and are not controlling or binding on the Commission in its determination as to reasonableness.

259 Turning now to the instant case, there are three issues. First, signing bonuses: We find that these bonuses are inappropriate to include in regulated rates. The Board of Directors made a decision about what it had to pay to entice officers with particular skills to come to the company and help transform it to the company the Board wanted Washington Water Power to become. The Board is free to pay whatever it could negotiate. However, our job is to determine what is appropriate to assign to ratepayers, and the evidence dictates against including signing bonuses in regulated rates. The signing bonuses were a one-time event that will not be a recurring, on-going business expense. Also, regarding Mr. Matthew's bonus in particular, the evidence supports a view that Mr. Matthews was hired to run an integrated company, and ratepayers should not be required to pay for unique experience and skills relevant to unregulated lines of business.

260 Next, regarding restricted stock awards: Avista makes a compelling argument for allowing these to be included in rates. Peer companies include stock as part of their overall compensation package. A reasonable Board of Directors seeks to align the interests of its executives with the overall success of the company, and owning a piece of the company through stock options is a commonly used means of achieving this end. Avista's Board of Directors has to compete within the labor market for executives, and, as Avista's brief observes, inclusion of restricted stock in a compensation package may be a necessary recruiting tool. The Board could have paid the entire amount of compensation in the form of cash, but instead decided to use

restricted stock as a portion of the executives' compensation package. However, the level of Mr. Matthews restricted stock is much greater than the amount paid to other officers. His restricted stock should be considered as part of his total compensation package. Except as conditioned in paragraph 262 below, executive compensation in the form of restricted stock will be allowed in rates.

261 Finally, regarding CEO compensation: As noted above, Mr. Matthew's base salary is $750,000. Leaving aside the signing bonus, he is also scheduled to receive restricted stock that significantly increases his total compensation. Commission Staff recommends allowing a base salary of $570,000 for ratemaking purposes, and disallowing Mr. Matthews' signing bonus and restricted stock. When the allocation formula approved in paragraph 250 is applied to $570,000, it results in a regulated salary of less than $300,000. Considering other Washington regulated company salaries, and the CEO salary levels of peer companies in the record, we believe this figure is too low. However, we believe that Mr. Matthews' total compensation – i.e, the sum of base salary plus restricted stock – is unreasonably high. *Ex. C-375, Ex. 374, p. 13.* The CEOs of Puget Sound Energy and PacifiCorp earn more, but are responsible for much larger utilities in terms of number of ratepayers and regulated utility sales. If Avista's unregulated operations become more valuable, then Mr. Matthews' compensation (through the growth in value of his restricted stock) will also grow.

262 Since we have allowed restricted stock as an element of executive compensation, paragraph 260 above, it is reasonable to approve a total compensation package for Mr. Matthews that includes his base salary plus an amount of restricted stock proportional to that received by other officers. *Ex. C375.* For ratemaking purposes, a total CEO compensation package of $785,775, equivalent to Mr. Matthews' base salary plus $35,775 in restricted stock, is reasonable. Applying our approved allocation between regulated and unregulated operations (52.3 percent to regulated operations) results in CEO compensation of $410,900 to be included in rates.

iv. Pro Forma Increase to Officers' Salaries

263 Avista makes a pro forma adjustment for officer salary increases that range, for different officers, from 11 percent to 49 percent. *Ex. 571, p. 4.*

264 Commission Staff argues these increases are unjustified, and recommends approving a 3.2 percent pro forma increase, based on three reasons. First, Staff argues that Avista's proposed pro forma increases are inconsistent with the increases the Company actually paid its executive officers. In 1997, Avista's Compensation & Benefits Committee granted all executive officers a 4% base salary increase *Ex. 398, page 7. 1997 proxy statement*. In 1998, the Committee granted executive officers base salary increases ranging from 3% to 11%. *Ex. 374, page 11. 1998 proxy statement*. In 1999, the Committee granted executive officers base salary increases ranging from 0% to 8%. *Ex. 397, page 11. 1999 proxy statement.* Second, Staff notes that Avista proposes a 2.14% wage increase for non-officers and 3% for union employees. Staff argues that to use 3.2 percent for pro forma officer salary increases is greater than either of these amounts. Staff notes that 3.2 percent also equals the overall United States wage and benefits increase, as quoted in the April 6, 2000, Wall Street Journal article entitled "Executive Pay." *Ex. T-570, page 8, lines 12-14.* Finally, Staff argues that Avista's proposed pro forma increases of 11% to 49% are entirely unjustified when measured against Avista management's recent performance.

265 Avista notes that its proposed pro forma salaries for the ten officers other than Mr. Matthews total $1,781,000 (before allocations to subsidiaries and other jurisdictions). The Company stresses that this sum is slightly less than the aggregate amount of $1,785,000 for the 50th percentile of the $1 to $3 billion peer group as shown in the Towers Perrin study. Avista argues that if Staff were to apply its recommendation of pegging the CEO's base compensation at the 50th percentile of the $1 to $3 billion peer group to the remaining 10 officers, there would essentially be no difference between that salary level and the Company's pro forma base compensation for those officers. *Tr. 1431, ll. 6-24.*

Commission Discussion and Decision

266 Avista faces market realities for paying officers, and we should defer to those market realities if they appear to be reasonable. The proxy statements to which Commission Staff points contain officer salary increases much higher than the 3.2 percent Staff recommends. We believe that some pro forma adjustment for officer salary increases is reasonable. We discussed Mr. Matthews' compensation in paragraphs 261 and 262. Removing his salary from Staff's "Adjustments to Officer Compensation" (*Ex. 571, p. 4*) shows an increase to the total officers' salaries from 1998 to 1999 of $150,836. This pro forma officer salary increase is appropriate to include in rates.

267 Based on Avista's non-contested pro forma adjustments, and our decision on the contested items discussed above, the Commission approves a pro forma adjustment to executive officers' compensation. This adjustment decreases net operating income for Washington electric by ($113,000) and Washington gas by ($39,000)

v. Team Incentive Bonuses (8A)

268 Avista's test year expenses include $4.4 million in team incentives. Commission Staff recommends removing this amount entirely. Staff's first reason is that the plans are not customer-service oriented and do not benefit regulated customers, and instead are tied to earnings per share and shareholder benefit. Staff's second objection is that if incentives are incorporated into rates, and if the Company does not pay those incentives in a given year, then ratepayers are disadvantaged. Staff notes that the level of team incentives paid by Avista has varied widely:

- In 1995, team incentive bonuses totaled $1,575,516.
- In 1996, they increased 20% to $1,895,544.
- In 1997, they decreased 45% to $1,039,373.
- In 1998, they quadrupled to $4,407,796.
- In 1999, they went down to zero.

269 As support for its recommendation, Staff points to the Commission's U S WEST rate case order, which said that team incentive plans not tied to goals benefitting ratepayers would face disallowance. *Docket No. UT-950200, 15th Supp. Order (April 11, 1996), p. 47.* The Commission disallowed similar team incentive awards to Puget Sound Power & Light. *Docket No. UE-920433, 11th Supp. Order (September 21, 1993), p. 61.* Staff argues that Avista's team incentive bonus goals are closely aligned with corporate earnings and, as a result, no bonuses were paid in 1999. *Ex. 570 p. 14.* The customer goals to which Avista points relate to only to three teams. Only one of those teams (Energy Delivery) has an explicit customer goal, yet two-thirds of that team's award is based on net operating income. *Ex. C-402.* In Staff's view, the fact that all team awards were nullified by a drop in corporate performance in 1999 shows the "illusory nature of the connection to customer-oriented goals for all areas." *Staff Brief, 22.*

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270 Avista argues that these incentives were disbursed widely throughout the organization and are a necessary recruitment and retention tool. The Company offers evidence of various targets that it claims produce customer benefits. *Ex. T-393, pp. 9-10.* Avista admits that the level has fluctuated, but notes that the five-year average of $1.8 million should be compared to Staff's recommendation of zero. The Company claims it is looking for ways to motivate employees to excel, "which will, in the broader sense, provide additional benefits to customers." *Ex 393, 11.*

Commission Discussion and Decision

271 Shareholders, not captive ratepayers, should bear the cost of these awards. Avista's team incentive bonuses will not be included in rates. As noted in *WUTC v. Washington Natural Gas Co., Docket No. UG-920840, 4th Supp. Order (1993)*:

> The Commission believes, however, that the Company can do a far better job in the future of creating incentives and setting goals that advantage ratepayers as well as shareholders. Such goals might include controlling costs, promoting energy efficiency, providing good customer service, and promoting safety. Plans which do not tie payments to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings.

272 The Commission disallowed cost of U S WEST's incentive bonuses in *Docket No. UT-950200, 15th Supp. Order (April 11, 1996),47-48.* The Commission decided:

> In the USWC plan, only a portion of the incentives were directly tied to service or service-related elements. The service goals were not met and that portion was not distributed. The income-related portion, however, was met and exceeded. What is particularly objectionable about this plan is not only that the financial incentives were independent of the service incentives, but the program was constructed so that, if the Company exceeded the stated financial goals by only 8%, employees could "replace" all of the bonus that they would "lose" for failure to achieve customer service goals. *[Footnotes omitted].*

273 We find that Avista's incentive bonuses contain the same flaws. Avista did not pay team bonuses when corporate earning goals were not met, no matter how well the Company's customer service performance might have been. As in the U S WEST case, this behavior clearly demonstrates that corporate financial goals trump customer

service goals. Consequently, these bonuses are appropriate for shareholders, not ratepayers, to fund. The Commission approves the Staff and Public counsel adjustment to remove team incentive bonuses. This increases net operating income by $1,435,000 for Washington electric, and $282,000 for Washington gas.

i. Public Counsel's Proposed Administrative and General Salary Adjustment

274 Public Counsel recommends an adjustment to reduce electric operating expenses by $4.16 million, and gas operating expenses by $1.06 million, by adjusting administrative and general salaries. According to Public Counsel, the Company's approach for determining officer compensation levels is flawed because Avista is not in the $3 to $6 billion category, there is no evidence that high executive salaries are appropriate to include in rates, and Mr. Matthews' bonus is excessive. To "bring the per-books administrative and general (A&G) salaries into line with what is reasonable for ratemaking purposes," Public Counsel recommends taking the A&G expense from Avista's last rate case and compounding it at the rate of inflation plus growth, arguing that this approach is firmly grounded in the Company's pre-diversification era.

Commission Discussion and Decision

275 The purpose of a rate case is to bring a company's costs and expenses into line with current events. Merely adjusting 10-year-old data would not represent sound ratemaking practice. For this reason, we reject Public Counsel's adjustment. And, we do not approve Public Counsels recommendation to increase electric net operating income by $1,242,000 and gas net operating income by $647,000.

j. Relocation Expenses Adjustment (10)

276 Avista includes all test period officer relocation costs, totaling $468,000. These 1998 officer relocation costs are more than four times the 1997 ($123,540) and 1999 ($110,000) levels. Avista was unable to provide data on officer relocation expense for the years 1993 through 1996. Avista argues that it's wrong to assume that relocation expenses remain at a constant baseline level, and that excluding 1998 is arbitrary.

277 Commission Staff believes that the 1997 and 1999 amounts are more representative of normal levels of relocation expenses than the test year amount, and averages those

two years to produce its recommended figure of $116,000. On brief, Staff indicates that its adjustment inadvertently omitted officer relocation expenses. Staff recommends that the Commission apply its subsidiary allocation to these expenses, and include the allocated portion in rates.

278 Public Counsel adopts the Staff's adjustment, stating that once adjusted, the test period is representative of prospective conditions, and that Avista did not show that the test year level of officer relocation costs is representative of what could be expected in the future.

Commission Discussion and Decision

279 Avista will undoubtedly have relocation costs each year, and should therefore recover a reasonable amount. It seems unlikely that the 1998 relocation expense will be duplicated, so we do not accept the Company's amount. However, the approach of choosing two lower years while ignoring a higher year as "non-representative" does not seem particularly sound, either. Averaging the three years of data will produce a reasonable relocation expense adjustment. Staff recommends that the Commission apply its subsidiary allocation to officer relocation expenses, and include the allocated portion in rates. We accept this proposal as well. The Commission approves an adjustment to test year relocation expenses to increase net operating income $64,000 for Washington electric operations and $16,000 for Washington gas operations.

k. Hydroplant Depreciation Adjustment (11)

280 Public Counsel proposes an adjustment to defer the collection of depreciation expense on Avista's hydroelectric plants. He represents that the market value of these plants exceeds their book value by seven-fold. *T-691, pp. 5-17.* He compares the hydroelectric plants to the Centralia plant, where the sale price was higher than original capitalized cost. He argues that accumulating any additional depreciation expense will amplify the great difference between book and market value (by reducing net book value) and may cause the ratepayer value in these plants to be harder to recover should the plants ever be sold. His proposed adjustment increases operating net income by $1,776,000, and increases rate base by $410,000, to reflect that the plants' book value is not being reduced by depreciation payments.

281 The Company opposes this adjustment. It argues that to eliminate depreciation on hydroplant based on the theory that the plants are worth more than their book value departs from original-cost (investment) ratemaking. Avista argues that the adjustment would imply that rates should reflect the market value of assets, yet the Company's rate base is not valued in that way for purposes of return on equity. Moreover, the Company argues that "This would violate a fundamental aspect of GAAP [Generally Accepted Accounting Principles], inasmuch as the Company would not be allowed to reflect any expense relating to assets that are being consumed." *Avista Brief, p. 91.* The Company argues that "This Commission should not engage in such a fundamental shift in regulatory philosophy without a comprehensive study justifying such a course." *Id.*

Commission Discussion and Decision

282 We decline to accept Public Counsel's proposed hydroplant depreciation adjustment. The Company points out correctly that Public Counsel's proposal conflicts with the principle of original-cost rate making. By arguing that the Company should not receive "return of" its investment through depreciation, the proposal invites the claim that "return on" the investment should be based on fair market valuation of the assets —a concept not employed for public utility rate making since its rejection by the Supreme Court in *Federal Power Comm'n v. Hope Natural Gas Company, 320 U.S. 591, 64 S. Ct. 281, 88 L.Ed.333 (1944).*

l. Metering and Billing (12)

i. Bimonthly Meter-Reading and Billing

283 Avista bills its customers on a monthly basis, and includes these costs as part of its expense. Public Counsel proposes a three-part adjustment based on bimonthly meter reading and billing: a reduction of O&M expense for cost savings associated with less frequent billing, an increase in uncollectibles, and a working capital adjustment to compensate for the time lag in matching operating revenues to operating expenses. Public Counsel points out that the Commission's rules only require utilities to read meters and bill every other month. Rendering bills every month is costly to the Company and to ratepayers. Public Counsel witness, Mr. Jim Lazar, cites several utilities that use bimonthly billing, including the largest public utilities in the state. According to Public Counsel, PSE, the state's largest electric utility, concluded that

there was a 90 percent chance that switching from bimonthly to monthly billing would have negative effects.

284 Avista believes that switching to bimonthly billing would have "significant negative consequences." There would be financial hardship for many customers. The magnitude of bimonthly bills in winter months would force customers to make payment arrangements. Many would opt for the monthly level-pay billing plan. Because billing represents 74 percent of combined meter reading and billing costs, there would be little or no savings with bimonthly billing if a majority of customers switch to monthly payment. *Avista Brief, 95.* Avista contemplates more high-bill complaints and special meter-reads as a result of bimonthly billing, and claims that past-due payments and uncollectible accounts would increase. According to the Company, customers do not support the change to bimonthly billing. A survey of 200 customers indicated that over 50 percent did not favor a switch to bimonthly billing. Another survey of other utilities revealed those that switched to bimonthly billing experienced a significant increase in customer complaints and past-due payments. Any projected cost savings was eroded by increased costs associated with additional customer complaints.

285 Avista makes three points in answer to Mr. Lazar's example of Western Washington utilities. First, utilities currently billing bimonthly have been doing so for a long time, so customer reaction is not an issue. Second, Western Washington enjoys much milder winters than Eastern Washington, with corresponding lower energy bills. Bimonthly bills in colder Eastern Washington may prove difficult for many customers to manage financially. Third, PSE has installed an automated meter reading system and now bills over two-thirds of its customers on a monthly basis.

Commission Discussion and Decision

286 We decline to accept Public Counsel's bimonthly meter-reading proposal. It is unreasonable to force a company to change its billing period unless it is in direct violation of a rule (i.e., if it had a three month billing cycle). As noted by the Company, with monthly budget pay plans available, more customers could opt for that service and defeat any billing cost savings. Perhaps most importantly, under bi-monthly billing, customers receive feedback on their consumption and the price of that consumption only once every 60 days. This lag runs in the opposite direction to more modern concepts of providing timely customer information and more accurate

price signals to influence behavior, and might ultimately prove counter-productive to conservation efforts. The Commission does not approve Public Counsel's proposal to increase electric net operating income by $993,000 and gas net operating income by $643,000. The Commission does not approve the rate base adjustments prepared by Public Counsel related to metering and billing for electricity and natural gas.

ii. Bill Inserts

287 Public Counsel raises another billing issue: bill inserts included with the monthly utility bill. Many of these inserts promote non-regulated activities. The Company admits these inserts are not utility-related and does not know if any of the billing costs are allocated to the benefitting non-regulated subsidiaries or recorded below the line. Public Counsel wants the Company to stop using promotional bill inserts outright.

Commission Discussion and Decision

288 Public Counsel's point is well taken. Using utility bills to advertise subsidiaries activities is unfair to competitors, as it gives the utility-affiliate free access to a captive audience. Ratepayers should not subsidize unregulated marketing activities. The Company is on notice that it should account for affiliate billing benefits and be prepared to make an appropriate allocation in future rate proceedings.

m. Excise and Franchise Tax Restatement (13)

289 This adjustment is in two parts, excise taxes and franchise fees. All parties agree to the Excise Tax part of the adjustment.

290 Avista seeks to include franchise fees for the cities of Spokane, Millwood, and Colville in the conversion factor. The effect would be to include the franchise fees in the overall revenue requirement and, as such, in the rates to all customers. Avista interprets RCW 35.21.860(2) to read that any franchise fee contracts in existence on or before April 20, 1982, may continue in effect in with no limitation as to whether they apply only to actual administrative costs. Avista contends the franchise fee contracts for the named cities have been in existence for "decades" and have been included in the rates to all customers.

291 Commission Staff interprets RCW 35.21.860(2) (as amended April 20, 1982) to read that franchise fees may continue in effect after April 20, 1982, only insofar as they cover actual costs. If the fees exceed actual costs, Staff claims they must be considered taxes. Staff sponsored a similar adjustment in the Northwest Natural Gas case in Docket No. UG-970932. Staff argues that Avista has not established that the franchise fees in question do not exceed the cities' actual costs and, therefore, recommends that the franchise fee component of the conversion factor be removed, and the Company recover the "taxes" through tariff municipal tax schedules 58 for electric and 158 for gas.

Commission Discussion and Decision

292 The issue presented is whether Avista should collect the franchise fees imposed by Spokane, Millwood, and Colville from all customers, or just from its customers in those cities. Avista loses no money either way. The Commission addressed the issue of franchise fees in a generic docket applicable to all utilities. *Docket Nos. U-79-43 and U-79-50 (May 13, 1980). Ex. 271.* The Commission concluded that franchise fees not exceeding 3 percent are reasonable expenses to include in general operating expenses. The Commission sees no basis in this record for revising this determination and therefore will not approve the Staff adjustment.

n. Hydroplant Relicensing Balancing Account

293 Avista successfully negotiated a settlement agreement allowing for relicensing of its Clark Fork hydroplants. The licenses are for a period of 45 years. Avista seeks to include the costs of the settlement in rates. It requests an increase to rate base of $9,277,000, as a regulatory asset to be amortized over 45 years. It also requests an annual expense level of $1,413,000 net of tax. No party contests these adjustments, and they are listed in Table 1 as uncontested adjustments and Table 8 as uncontested adjustments.

294 In addition to these adjustments, however, Avista also seeks to establish a balancing account in which it can track amounts which vary from the normalized level of annual expenses. Avista asks that any balance in the balancing account be refunded or surcharged in its next general rate filing, or in a separate filing, if no general case is filed in the next three years.

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295 Commission Staff objects to Avista's request for a balancing account. Staff claims that its investigation of available data did not show that expenses for Clark Fork hydroplant relicensing vary significantly from year to year. Thus, Staff argues, Avista has not established a need for a balancing account.

296 Public Counsel argues that a mechanism that virtually guarantees the Company recovery of all costs is inappropriate.

Commission Discussion and Decision

297 The problem with a true-up account of this nature is accountability. Unless there is no adequate method of forecasting the re-licensing costs, a balancing account is not necessary. As previously discussed, ratemaking sets a normal level of expenses, providing an incentive to the Company to keep costs at, or below, normal. If extraordinary costs are incurred, the company may seek an accounting order. We reject the Company's request at the time for a balancing account.

o. Property Disposition Study

298 There is no contested issue raised in this proceeding regarding the disposition of gain on depreciable or non-depreciable property. However, Public Counsel notes that Exhibit 620 demonstrates that the Company sold several million dollars of property in recent years. Public Counsel also notes that Commission Staff did not do an analysis of the Company's gain on these property sales, and that this issue has been an important one in past rate cases. Public Counsel recommends that ". . .the gain on sale of real property since the previous rate case continue to be deferred for treatment in a future rate case." *Public Counsel Brief, p. 60.* To be consistent with precedent, Public Counsel recommends that in future rate cases the Staff should be directed to prepare an analysis of gain on property sales. *See decisions in U-85-53, U-89-2688-T, U-89-2688-T settlement of appeal.*

Commission Discussion and Decision

299 While Public Counsel criticizes the Staff's failure to perform an analysis of the Company's gain on property sales, we note that Public Counsel *also* failed to perform an analysis of the Company's gain on these sales. The only request Public Counsel appears to make is for the Commission to direct Staff to look at this issue in future

cases, and to allow "...the gain on sale of real property since the previous rate case [to] continue to be deferred for treatment in a future rate case." We grant this request and ask Staff to analyze this issue in future cases. We will require Avista to continue to defer the gain on sale of real property since its previous rate case until its next rate case.

3. Conclusion: Net Operating Income

300 Avista's adjusted net operating income for electrical operations, for ratemaking purposes, is $52,079,000. This amount is the sum of Avista's rate year results of operations for electrical operations of $61,733,000, non-contested adjustments totaling $(6,543,000), and contested adjustments, as determined by the Commission, of $(3,111,000). Avista's adjusted net operating income for gas operations, for ratemaking purposes, is $9,798,000. This amount is the sum of Avista's rate year results of operations for gas operations of $8,482,000, uncontested adjustments totaling $1,249,000 and contested adjustments, as determined by the Commission, of $67,000.

D. Rate Base

301 The appropriate rate base is derived from the balance sheets of the test period. This rate base is adjusted to reflect new additions and reductions to the Company's invested capital, including regulatory assets . The rate base represents the net book value of assets provided by investors' funds which are used and useful in providing utility service to the public.

1. Non-Contested Rate Base Adjustments

302 Many of the proposed adjustments to the 1998 rate base have been agreed to by all of the parties. These non-contested adjustments are shown in the following two tables. The Commission has reviewed the proposed non-contested adjustments, and finds them to be reasonable for purposes of setting rates in this proceeding.

Table 8 Table of Non-Contested Electrical Rate Base Adjustments

Table 8 Table of Non-Contested Electrical Rate Base Adjustments (Washington Jurisdiction) ($000)	
Non-Contested Adjustments - Electric	**Rate Base**
Deferred Federal Income Tax Rate Base	(100,419)
Deferred Gain -Office Building	(1,000)
Colstrip 3 AFUDC Elimination	(3,736)
Colstrip Common AFUDC	746
Kettle Falls Disallowance	(1,841)
Weatherization and DSM	21,408
Customer Advances	(1,361)
Depreciation	(157)
Clark Fork Hydroplant Relicensing	9,277
MOPs	351
Total Non-Contested Adjustments	(76,732)

Table 9 Table of Non-Contested Gas Rate Base Adjustments

Table 9 Table of Non-Contested Gas Rate Base Adjustments (Washington Jurisdiction) ($000)	
Non-Contested Adjustments - Gas	**Rate Base**
Deferred Federal Income Tax Rate Base	(10,305)
Deferred Gain on Office Building	(348)
Gas Inventory	1,458
Weatherization and Demand Side Management	3,684
Customer Advances	(99)
Depreciation	(12)
Total Non-Contested Adjustments	(5,622)

2. Contested Rate Base Adjustments

303 Contested adjustments are those adjustments to the 1998 test year rate base sponsored by one or more parties to the proceeding, and contested by one or more parties. Some issues apply to both gas and electric rate base. All of the contested adjustments for

gas operations reflect similar adjustments for electrical operations (although there are several electrical issues that are not present in our analysis of gas operations).

Table 10 Table of Contested Electrical Rate Base Adjustments

Table 10 Table of Contested Electrical Rate Base Adjustments (Washington Jurisdiction) ($000)				
Contested Rate Base Adjustments - Electric	Company	Commission Staff	Public Counsel	Commission
Centralia Sale (1)	(12,460)	0	0	(12,460)
Centralia Gain Amortization (2)	(11,162)	0	0	0
PGE Contract (3)	0	(60,065)	(43,852)	(93,621)
Hydroplant Depreciation (4)	NP*	NP*	410	0
Meter Reading and Billing (5)	NP*	NP*	4,249	0
Total Contested Rate base Adjustments	(23,622)	(60,065)	(39,193)	(106,081)

* No Position

Table 11 Table of Contested Gas Rate Base Adjustments

Table 11 Table of Contested Gas Rate Base Adjustments (Washington Jurisdiction) ($000)				
Contested Rate Base Adjustments -Gas	Company	Commission Staff	Public Counsel	Commission
Meter Reading and Billing (5)	NP*	NP*	2,114	0
Total Contested Rate Base Adjustments	0	0	2,114	0

* No Position

a. Centralia Sale (1)

304 As discussed in paragraphs 187-196, Commission Staff, Public Counsel, and ICNU asked the Commission to continue to treat the Centralia Power Plant as if the Company had not sold the facility, until such time as long-term power replacement plans are made and found to be prudent. This treatment would have included retaining Avista's formerly owned portion of the Centralia power plant in rate base. The Commission determined that this treatment is not appropriate, and approved Avista's inclusion of replacement power costs in its adjusted results of operations. Correspondingly, the $12,460,000 rate base reduction sought by Avista should be made.

b. Centralia Gain Amortization: Return of Customer Share of Gain (2)

305 Avista sold its ownership share of the Centralia power plant to TransAlta in Spring 2000. The Commission approved the sale in the Commission's *Second Supplemental Order* on March 6, 2000, and in its *Fourth Supplemental Order* on April 21, 2000, in *Centralia*.[10] In the Orders, the Commission established the method for calculating the portion of the gain from sale of the Centralia Plant to be allocated to customers. These Orders also directed that the disposition of this gain be addressed in this proceeding.

306 The sale has now closed and the Company has provided near-final figures regarding net proceeds. *Ex. 448.* The customer portion of the final gain for Avista's 17.5 percent share of the plant is indicated in this exhibit to be $19,869,296 for the Washington jurisdiction.

307 The Company proposes that this gain be used first to offset Icestorm costs, with the remaining balance amortized over an eight-year period, consistent with a recent order of the Idaho Commission.

308 The Company-proposed treatment of the Centralia gain derives from its proposal concerning Centralia replacement power costs, its proposed eight-year amortization of the gain (net of Icestorm costs), and its proposed rate base reduction, including the effect of its proposed rate of return. The Company's proposal to return the gain to

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[10] *Id.,* Footnote 1.

customers through an eight-year amortization includes a reduction to rate base of $11,162,000. According to Avista, the net effect of its proposed treatment of the Centralia gain is a reduction to revenue requirement of approximately $2,000,000.

309 Commission Staff originally recommended returning the gain to customers over roughly 15 years as an offset to the Demand Site Management (DSM) tariff rider. On brief, Staff abandons its DSM tariff proposal, and adopts the Company's recommendation of an eight-year amortization period, but objects to the use of the gain for Icestorm cost recovery. Removing the Icestorm costs from Exhibit 448, the Staff calculates a net revenue requirement reduction of $6,575,763. Staff is silent in its Brief regarding Staff's original proposal to adjust the interstate allocation factor. By accepting the Company's calculation of the Washington share of the gain, Staff has apparently abandoned its original proposal to make minor adjustments to this allocation factor. Finally, Staff indicates that the methods used by either PacifiCorp or Puget Sound Energy (PSE) to return the Centralia gain to their ratepayers could appropriately be considered by the Commission in deciding how to return Avista's customers' share of the Centralia gain.

310 Commission Staff notes that the settlement in the recent PacifiCorp rate case included a five-year amortization and return of its customers' share of gain through a bill credit.[11] Additionally, in our Fifth Supplemental Order in *Centralia* (August 22, 2000), the Commission has now approved a one-time bill credit that will allow PSE to immediately return to its customers their share of the Centralia gain.

311 Public Counsel has not proposed any specific approach for returning to Avista's customers their portion of the Centralia gain. He has objected to inclusion of Oregon and California state income taxes in the calculation of the gain. Public Counsel argues that Avista has only natural gas customers in Oregon and California. He argues that these gas ratepayers have paid nothing toward the cost of Centralia and will pay nothing toward the cost of replacing Centralia power. According to Public Counsel, "... [r]atepayers in this state should not be made worse off because of a decision by Avista to expand its gas operations into other states." *TR-691, p. 31, ll. 7-8.* Public Counsel calculates that removing California and Oregon income tax from the calculation of gain allocated to Washington customers increases that gain by $337,676. *Public Counsel Brief, p. 59.*

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[11] *WUTC v. PacifiCorp*, Docket No. UE-991832 (August 9, 2000).

312 ICNU objects to the Company's proposal to recover Icestorm costs with the portion of Centralia gain allocated to customers. ICNU proposes that the full gain, grossed up for revenue requirement, be returned to customers as a bill credit, amortized over eight years. ICNU further recommends that the unamortized balance in the billing credit account earn interest at the Company's authorized rate of return. Finally, ICNU indicates it would not be opposed to a five-year amortization, as we approved for PacifiCorp in Docket No. UE-991832.

313 The Company opposes Public Counsel's proposal that Oregon and California state income taxes be removed from the calculation of the gain. The Company argues that the tax costs should not be assigned to its gas operations in Oregon or California, because they are based on the sale of an electricity asset. The Company argues that these taxes are a cost of doing business and are just as legitimate as federal income taxes. The Company also opposes Commission Staff's recommendation to modify the jurisdictional allocation percentage, pointing out that Staff's proposal is inconsistent with the production/transmission allocation factor applied to the test year in this proceeding. Further, according to the Company, the net effect is to reduce the allocation of gain to Washington.

Commission Discussion and Decision

314 The Commission has already determined that Icestorm costs should not be recovered. Therefore, the Company's proposal to use a portion of the customer share of the Centralia gain to offset Ice Storm costs is not aproved.

315 The PSE method of returning the customers' share of the Centralia gain by a one-time bill credit has features that are appealing in the case of Avista, as well. If the sale proceeds are passed through now, they will not affect the level of rates set in this proceeding. Avista will not have to pay interest at its authorized rate of return on the unamortized balance of the fund. The Company has the cash in hand now; it can be returned to ratepayers now. The customers will benefit from immediate receipt of their portion of the benefits, and may use it as they think best. Finally, Avista's on-going rates will not reflect a reduction that may be misleading because it is the result of the return to ratepayers of an asset value rather than a reduction in on-going expenses.

316 The Commission will order Avista to return its customers' share of the Centralia sale proceeds by a bill credit, with the refund to be complete by March 31, 2001. The Company should present its proposal for compliance with this requirement no later than thirty days after the service date of this order. Avista must pay interest on the gain at its authorized rate of return until the bill credit is accomplished.

317 The rate base reduction of $11,162,000 proposed by the Company as part of returning the gain over eight years is therefore unnecessary and is not approved.

318 The final issue is Public Counsel's concern about state income taxes. Even though Avista does not provide electric service in Oregon or California, those states are imposing state income tax on the Centralia gain. Taxes are a cost of doing business. While it may seem unfair that California and Oregon tax electric proceeds attributable to Washington activity, it does not follow that the burden should therefore be borne solely by shareholders. Avista will be allowed to deduct the California and Oregon income tax from the gain allocated to Washington customers.

c. PGE Contract Rate Base Reduction (3)

319 As discussed in paragraphs 75-116, the Commission has determined that Avista should use portions of the PGE test year contract buydown to offset certain assets in rate base. To implement this decision, a $93,621,324 reduction to rate base should be made. This reduction includes rate base adjustments to eliminate the DSM/Weatherization increase rate base (included in Table 8), and to reduce rate base an amount equivalent to the balance in the Rathdrum Lease. After accomplishing these adjustments, the reduction includes the remainder of $37,528,000 in test year buydown funds amortized straight-line over an eight-year period. The spreadsheet attached as Appendix A documents the components of the PGE Contract Rate Base Reduction. The format is that used by Staff in Appendix B to Staff's Brief.

d. Hydroplant Depreciation Deferral (4)

320 In Paragraph 282 the Commission denied Public Counsel's proposed hydroplant depreciation adjustment. This proposal included deferral of hydroplant depreciation and an upward adjustment to rate base. Public Counsel's proposed electric rate base adjustment is likewise denied.

e. Bimonthly Meter Reading and Billing (Electric and Gas) (5)

321 In Paragraph 286 the Commission denied Public Counsel's bimonthly meter-reading proposal. Public Counsel's proposed rate base adjustment will likewise not be made for either electric or gas operations.

3. Conclusion--Rate Base

322 Avista's adjusted rate base for electrical operations, for ratemaking purposes, is $553,316,000. This amount is the sum of Avista's rate year rate base for electrical operations of $736,129,000, non-contested adjustments totaling ($76,732,000) and contested adjustments, as determined by the Commission, of ($106,081,000). Avista's adjusted rate base for gas operations, for ratemaking purposes, is $119,919,000. This amount is the sum of Avista's rate year rate base for gas operations of $125,541,000, non-contested adjustments totaling $(5,622,000) and contested adjustments, as determined by the Commission, of $0.

E. Rate of Return

323 Return on capital reimburses investors for allowing the Company to use their dollars, and is a major portion of Avista's overall rate request. Rate of return is the weighted average cost of the utility's various sources of capital, and is the amount of money it must spend to obtain the capital it uses to provide regulated products.

324 A utility is entitled to the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return comparable to other enterprises of corresponding risk. *Duquesne Light Company v. Barasch, 488 U.S. 299, 310, 312, 109 S.Ct. 609, 102 l. Ed. 2d 646, 98 P.U.R. 4th 253 (1989); Federal Power Commission v. Hope Natural Gas Co.I, 320 U.S. 591 (1944); Bluefield Water Works Improvement Co. v. PSC of West Virginia, 262 U.S. 679 (1923).*

325 Three parties (Avista, Commission Staff, and Public Counsel) provided testimony regarding the appropriate rate of return. Each retained outside consultants to provide their expert opinions to the Commission: Dr. William Avera on behalf of Avista; Dr. Richard Lurito on behalf of Staff; and Mr. Stephen Hill on behalf of Public Counsel.

326 Avista, Commission Staff, and Public Counsel agree on certain fundamental issues: Avista's embedded cost of debt and preferred stock; estimating the cost of equity based on groups of comparable utilities, rather than looking directly at Avista; and applying a discounted cash flow (DCF) model to estimate the cost of equity for comparable groups of utilities, based on the fundamental premise that this will serve to "replicate investor's expectations" when they pay the current market price for utility common stocks. *Ex. T-135, p. 1, ll. 14-21.*

327 The differences in the overall rates of return recommended by the parties result primarily to differences in their costs of common equity and capital structures, and secondarily to differences in the cost of long-term debt. The calculation of cost rates for debt and preferred stock is fairly straightforward. The cost of equity estimate is not as easily determined by reference to objective data, and presents many more questions we must resolve. In addition, the Company has asked to be allowed to earn an increment over the top of the range of reasonable rates of return, as an incentive for superlative service.

1. Cost of Common Equity Capital

328 The cost of common equity capital, stated as a rate of return on common equity, is a function of several variables, and is primarily an attempt to quantify a rate of return required by investors for that particular investment.

329 All three of the experts provide Discounted Cash Flow (DCF) studies. The DCF model relies on the equivalence of the market price of stock with the present value of the cash-flows investors expect from the stock. The total return to the investor, which equals the required return according to this theory, is the sum of the dividend yield and the expected growth rate in the dividend.

330 DCF studies compare the utility whose cost of equity is the focus of the study (Avista) to the return found appropriate for a group of companies that are of comparable risk to Avista's regulated utility operations. All three studies estimate the cost of equity based on groups of comparable utilities, rather than looking directly at Avista.

331 One of the areas where the parties diverge is in their selection criteria for "comparable" companies. Dr. Avera, on behalf of Avista, used four criteria to select companies: 1) gas utility operations; 2) an "A" rating by Moody's or Standard and

Poor's; 3) utility revenues equal to at least 80 percent of total revenues; and 4) not involved in a major merger or acquisition. These produced Dr. Avera's group of 12 comparable companies.

332 Dr. Lurito, for Staff, used six selection criteria: 1) a dividend payout ratio of 70 percent to 90 percent in 1999; 2) a current dividend yield in excess of 7.0 percent; 3) no dividend cut over the 1989-1999 period; 4) a company not currently in a merger/acquisition mode; 5) a company that has not been involved in a significant merger/acquisition for at least ten years; and 6) a company whose non-regulated business revenues in 1999 account for about 30 percent of total revenues or less. Applying these criteria, Dr. Lurito produced a group of five electric and combination utilities.

333 Dr. Lurito testifies that his group of five utilities is more comparable to Avista Utilities because: its electric/gas revenue mix is comparable to Avista Utilities; its average bond rating from Standard & Poor and Moody is similar; and its March 31, 2000 dividend yield, allowed return on equity, 1999 earned return on equity, and March 31, 2000 market-to-book ratio are more risk-comparable to the regulated operations of Avista.

334 Dr. Avera, for Avista, compared cost of equity estimates for Dr. Lurito's group to yields on single-A public utility bonds, which reached approximately 8.8 percent by May, 2000. He criticizes Dr. Lurito's individual equity estimates for two of Dr. Lurito's comparable companies, CH Energy and United Illuminating, arguing that Dr. Lurito's analysis indicated that the average cost of equity for these two firms was 7.99 percent and 8.50 percent, respectively. Avista argues that if one were to exclude these "illogical values" for CH Energy and United Illuminating, the resulting cost of equity estimate for Dr. Lurito's group would be approximately 11.0 percent. *Ex. T-135, pp. 15-16.*

335 Mr. Hill, on behalf of Public Counsel, selected his comparable companies by screening all of the combination gas and electric firms listed by C. A. Turner Utility Reports and the Value Line Investment Survey. His selection criteria include: 1) companies that had at least 50 percent of revenues from electric utility operations; 2) companies with no recent dividend cut; 3) companies not merging; and 4) companies with investment-grade bond ratings that bracket those of Avista. He eliminated

companies that had recently experienced or were projected to experience shifts in book value. Eight "comparable" companies were selected.

336 None of the experts selected Avista Corporation as one of its comparable companies. Avista Corporation has significant unregulated operations which make its overall risk profile higher than that of its regulated utility operations.

337 Dr. Lurito and Mr. Hill sponsored standard DCF studies, while Dr. Avera provided the results of a "multi-stage" DCF study.[12] In order to perform a "multi-stage" DCF analysis, Dr. Avera had to make several critical assumptions, the most important of which are:

338 (1) All of his 12 comparable companies will have a fully deregulated, fully competitive generation segment by 2008.

339 (2) All 12 utilities will have 50 percent of their investment in generation and 50 percent in transmission/distribution.

340 (3) All of these generation segments will enjoy a 10.4 percent per year earnings per share (EPS) growth forever beyond 2008.

341 (4) All of the 12 utilities will enjoy a 7 percent per year EPS growth forever beyond 2008 on a total-company basis (generation plus distribution/transmission).

342 (5) All of these utilities' generation segments will account for 50 percent of total assets.

343 (6) All of these 12 companies will have a 60 percent payout ratio forever beyond 2008. *Ex. T-632, pages 34-35.*

344 These assumptions, among others, led Dr. Avera to conclude that the cost of equity based on his DCF approach is 10.9 percent to 11.9 percent. *Ex. T-101, p. B-7.* Based on this study and other studies he performed, Dr. Avera recommends a return on

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[12] Dr. Avera and Mr. Hill also provide various other studies by which they test the reasonableness of the DCF result.

equity for Avista of 12.0 percent, with an additional 25 percent added for exemplary customer service.

345 Dr. Lurito and Mr. Hill perform single-stage DCF studies as the foundation of their analyses. Dr. Lurito claims that by selecting electric/gas utilities that have sufficiently stable pasts and futures, an analyst can use the single-stage DCF approach to make reliable for estimates cost of equity.

346 Dr. Lurito calculates a cost of equity for Avista of 10.02 percent to 10.23 percent. He averages these to 10.13 percent, then rounds this up to a recommendation of 10.15 percent. He then adds 4 percent for financing cost. His final recommended cost of equity is 10.4 percent.

347 Mr. Hill testifies that as capital costs have declined during the last decade, the DCF has produced appropriately lower equity cost estimates. He indicates that in his experience, utility-sponsored rate of return witnesses have attempted to convince regulators that standard DCF results are unacceptably low. He goes on to testify that the standard DCF continues to be the most widely used equity-cost estimation method used in regulation. Mr. Hill's average DCF cost of equity capital for his entire group of comparable companies is 11.08 percent. Based on this study and other studies he performed, Mr. Hill determines that a reasonable range for return on equity is from 10.5 percent to 11.25 percent. He recommends that the Commission set return on equity at the mid-point of this range, 10.875 percent.

348 Dr. Lurito emphasizes that the allowed return on equity for his group is 11.4 percent and its earned return on equity is 11.3 percent. For Dr. Avera's group, the allowed return on equity is 11.7 percent and the earned return on equity is 13.9 percent. Dr. Lurito argues that this is evidence that Dr. Avera's group has unregulated segments providing significant earnings, and that these unregulated earnings increase the earnings-per-share growth expectations of investors.

349 Dr. Lurito also notes that his group's average market-to-book ratio is 1.15, while the market-to-book ratio of Dr. Avera's group is nearly 1.5. Dr. Lurito cites this as additional evidence that Dr. Avera's group is more speculative and less comparable to the regulated operations of Avista Utilities. Dr. Lurito uses a market-to-book ratio of 1.04 as a proxy for what the regulated operations of Avista should earn.

350 Mr. Hill, for Public Counsel, also relies on the significance of the relationship between a utilities market-to-book ration the expected book return, and the cost of equity documented in financial literature.

351 Another dispute among the experts is whether the Commission should add a financing cost, or flotation cost, to the "bare" cost of equity. Dr. Avera includes a 25 basis point flotation-cost addition in reaching his recommended fair rate of return.

352 Dr. Lurito testifies that if the stock of Avista Utilities (as opposed to Avista Corporation) traded in the market and if it earned 10.15 percent on its common equity capital it would have a market-to-book ratio of 1.0. He adds a financing-cost allowance to allow Avista Corporation to recoup sunk financing costs related to past common stock sales. This would allow Avista Utilities to maintain a 1.04 market-to-book ratio. This cost financing equals 25 basis points. The addition of this financing cost increases Dr. Lurito's estimate of the cost of equity to 10.4 percent.

353 Mr. Hill testifies that it is unnecessary to account for flotation costs because: 1) Avista common stock is currently selling for a price above book value; 2) Avista has presented no evidence of any near-term intention to issue common stock (and in fact the Company is engaged in a common stock buy-back); 3) Mr. Avera's 25 basis point flotation cost addition to the Company's cost of equity would raise Avista's jurisdictional revenues by about $1.25 Million annually; 4) the majority of issuance expenses are underwriters' discounts that are not out-of-pocket expenses for the issuing Company; 5) Mr. Hill's DCF growth rate includes an upward adjustment to equity capital costs which accounts for investor expectations of stock sales at prices in excess of book value; and 6) research has shown that a specific adjustment for issuance expenses is unnecessary.

354 On rebuttal, Dr. Avera notes that both he and Dr. Lurito agree that a 25 basis point upward adjustment needs to be made to recognize floatation costs. He notes that Mr. Hill's first two reasons may be factually true, but argues they are irrelevant. He argues that a flotation-cost adjustment is needed to compensate for costs incurred from past issues of common stock. He claims that the flotation costs incurred in connection with a sale of common stock are not included in a utility's rate base because the portion of gross proceeds that is used to pay these costs is not available to invest in plant and equipment.

Commission Discussion and Decision

355 While the determination of the cost of common-equity capital requires the exercise of judgment, the use of judgment must be informed by the facts. If meeting the burden of proof through opinion testimony has any meaning, it means that the witness must present a logical connection between the factual evidence presented and the opinion offered. The six critical assumptions that are required for Avista's multi-stage DCF analysis do not appear to be based on reasonable factual assumptions. Consequently, the Commission will place greater weight on the DCF analyses of Dr. Lurito and Mr. Hill in determining the return on equity appropriate for Avista.

356 In addition, the comparable groups chosen by Commission Staff and Public Counsel more closely reflect those of Avista's regulated utility operations in Washington. The comparison of the current allowed return to the current earned return for each group of comparable companies indicates that Dr. Lurito and Mr. Hill have chosen comparable companies which better reflect the risks faced by a regulated energy provider. This is not to say that Avista faces no risks; the risks currently facing all regulated electricity and gas utilities are also there for the comparable companies. The market-to-book ratios of the comparable companies chosen by Staff and Public Counsel indicate that those comparable companies are not over-earning, at least not at the levels shown for Avista's comparable companies.

357 The Commission agrees with Avista, however, that Dr. Lurito's cost of equity estimates for CH Energy and United Illuminating are inappropriate because they fall below the 8.8% current yield on single-A public utility bonds. We will remove these two estimates. The resulting cost of equity from Dr. Lurito's DCF study is approximately 11.0 percent, which we find to be reasonable.

358 The Commission also agrees with both Dr. Avera and Dr. Lurito that a 25 basis point markup for floatation costs should be made. This amount compensates the Company for costs incurred from past issues of common stock. Floatation costs incurred in connection with a sale of common stock are not included in a utility's rate base because the portion of gross proceeds that is used to pay these costs is not available to invest in plant and equipment.

359 The Commission believes that a range of returns between 11.00 percent (Dr. Lurito's DCF result as adjusted) and 11.33 percent (Mr. Hill's DCF result plus 25 basis points

for floatation costs) is reasonable. We will set Avista's authorized return on equity at the mid-point of the range: 11.16 percent. This return is also within the 10.9 to 11.9 percent range resulting from Dr. Avera's multi-stage DCF study. *Ex. T-101, p. B-7.*

2. *Cost of Debt*

360 There is no substantial conflict among the parties regarding the cost of fixed-income capital— capital whose cost rate is contractually set (e.g., preferred stock, preferred securities, long-term debt and short-term debt). The only disagreement over cost rates of fixed-income capital relates to the time period from which those costs are taken. All parties agree that all fixed-income capital costs should be those of Avista's utility operation.

a. Cost of Long-term Debt

361 In the Company's case-in-chief, Dr. Avera found the cost of debt to be 7.83 percent at June 30, 1999. In response to data requests, he recomputed that cost rate at March 31, 2000 to be 7.308 percent. *Ex. 149.* Dr. Lurito, for Commission Staff, testified that his original and his revised testimony used the cost of long-term debt developed by Dr. Avera.

362 However, Dr. Lurito testified that Dr. Avera's 7.308 percent cost rate for long-term debt fails to account for $110 million of preferred trust securities, which should be treated as long-term debt. When that factor is taken into consideration, that rate becomes 7.44 percent. *Ex. T-632, page 5, revised June 28, 2000.* Mr. Hill recommended a 7.45 percent rate *(Ex. 627, Schedule 12)*, virtually the same as Dr. Lurito's 7.44 percent.

363 The Commission will set the cost rate of long-term debt at 7.45 percent.

b. Cost of Short-term Debt

364 Dr. Avera did not include a component for short-term debt in his proposed capital structure. On rebuttal, Avista witness Jon Eliasson argues that if short-term debt is included in the capital structure, the cost should reflect the most current actual rates the Company is experiencing, and that a reasonable cost should be at least 7%.

365 Dr. Lurito used the principle of applying the most recent cost rates for debt as the basis to propose a short-term debt rate of 6 percent. Dr. Lurito testified that he did not use the precise rate of 6.98 percent, the cost of short-term debt at March 31, 2000, because it appears to be a temporary spike in those rates. He notes that Mr. Eliasson's Exhibit 521, page 3, lists the monthly cost of short-term debt incurred by the Company from January 1999 to May 2000, which never rises to the 7.0 percent rate that Mr. Eliasson used in his testimony. *Ex. 520, page 9, lines 7-8.* The average monthly cost of short-term debt over that period was 5.79 percent. *TR page 1862, lines 22-25.*

366 The Commission will set the cost of short-term debt at 6.39 percent. This is the average cost of the most recent six months of short-term debt costs included in Exhibit 521.

c. Cost of Preferred Stock

367 Dr. Avera used an 8.11 percent cost of preferred stock in the Company's case-in-chief. Dr. Lurito, for Commission Staff, notes that there was no change in the amount of preferred stock outstanding between mid-year 1999 and the end of the year. He adopts Dr. Avera's 8.11 percent cost of preferred stock. Mr. Hill, for Public Counsel, uses the same figures, which he calculates based on an 8.151 percent cost for preferred stock and an 8.07 percent cost of trust preferred.

368 The Commission will set the cost of preferred stock at 8.11 percent.

3. Capital Structure

369 The Company asks the Commission to adopt a hypothetical capital structure of 47 percent long-term debt, 6 percent preferred stock, and 47 percent common equity capital. This capital structure was derived from the average 1998 year-end capital structure ratios for the "comparable" companies Dr. Avera identifies in his cost of equity study. Avista does not include a short-term debt component in this capital structure.

370 Both Commission Staff and Public Counsel include short-term debt as a portion of the capital structure, arguing that Avista consistently uses short-term debt to finance its operations.

371 Dr. Lurito recommends the use of Avista's consolidated capital structure for rate setting purposes. That capital structure consists of approximately 42 percent common equity and 58 percent fixed-income capital. *Exhibit T-632, p. 1.* Dr. Lurito argues that this rate structure provides an appropriate balance between two long-standing principles of sound ratemaking: 1) that a utility is entitled to earn a return on capital sufficient to preserve its creditworthiness and sufficient to permit it to sell additional debt and equity capital on reasonable terms; and 2) that the rate of return on capital must not burden ratepayers unnecessarily, i.e., it must be economical.

372 In order to demonstrate that the capital structure he recommended meets this critical safety/economy standard, Dr. Lurito showed that his capital structure and related overall rate of return recommendation produced a pre-tax interest coverage ratio of 3.27x.[13] This 3.27x is at the upper end of the 2.5x to 3.4x Standard & Poor's (S&P) guideline necessary to achieve a BBB to A rating. *Ex. T-632, page 28.* Avista Corporation's debt is rated BBB+ by S&P and A3 by Moody's. *Ex. 634, Schedule 1.* Dr. Lurito also showed that his recommended capital structure and overall rate of return will produce a funds from operations interest coverage of 4.6x and a funds-from-operations-to-total-debt ratio of 28.2 percent. *Id., pp. 28-29.* Only a 3.8x funds-from-operations coverage is needed for an A rating, and just a 25.3 percent funds from operations to total debt ratio is needed for an A rating, according to S&P's guidelines.

373 The capital structure recommended by Public Counsel is based on Mr. Hill's measure of Avista's actual utility-only capital structure. In support of this choice, Public Counsel notes that this capital structure is representative of the manner in which Avista's management has elected to capitalize its utility operations over the past few years and, importantly, the manner in which it expects to capitalize those operations in the future. Mr. Hill calculated the Company's utility-only capital structure in the same manner that Avista itself made that calculation in its most recent rate proceeding in Idaho. *Exhibit 119.* A six-quarter average of Avista's utility-only capital structure consists of approximately 39 percent common equity and 61 percent long-term debt,

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[13] When used in discussion of the pre-tax interest coverage ratio, "x" is equivalent to "times," i.e., a ratio of 3.27x means that the Company's net income is 3.27 times greater than its annual interest expense. The ratio is used to determine how much risk exists that a company's bondholders will not be paid. Bond rating agencies, therefore, use the ratio as a guideline for determining what rating should be assigned to a company's bonds.

preferred securities, and short-term debt. That capital structure is also very similar to the manner in which the electric utility industry is currently capitalized – 40 percent common equity and 60 percent fixed-income capital. *Exhibit T-623, Schedule 2.*

Commission Discussion and Decision

374 The Commission agrees with Dr. Lurito that a just and reasonable capital structure is one that provides a reasonable balance between financial safety and economy. Avista proposes a capital structure of 47 percent long-term debt, 6 percent preferred stock, and 47 percent common equity capital. We do not accept Avista's proposed capital structure because it includes no short-term debt. Accounting for Avista's actual use of short-term debt drives the equity share down. Dr. Avera's recommendation for common equity share appears to be biased to the high side.

375 Both Commission Staff and Public Counsel properly include short-term debt as a portion of the capital structure. Avista consistently uses short-term debt to finance its operations. Because common equity, on a pre-tax, ratemaking basis, is approximately twice as expensive as debt capital, use of a capital structure that correctly portrays Avista's use of short-term debt is a more accurate reflection of the Company's actual cost of money. *Exhibit T-622, pp. 21, 22.*

376 The capital structure recommended by Public Counsel is based on Mr. Hill's measure of Avista's actual utility-only capital structure, and contains 39 percent common equity and 61 percent long-term debt, preferred securities and short-term debt. Simply removing Avista's unregulated operations from the capital structure, as Mr. Hill has done, appears to require the assumption that the unregulated operations of Avista are funded with 100% equity. That is not a realistic, long-range assumption. The common equity share in Mr. Hill's capital structure appears to be biased to the low side.

377 The capital structure proposed by Dr. Lurito is based on Avista's actual capital structure, and does not suffer from any obvious bias. We accept Dr. Lurito's proposed structure of 42 percent common equity and 58 percent fixed-income capital. In determining the composition of the fixed-income capital, the Commission has examined Avista's average mix of debt instruments for consolidated operations for the last six quarters. *Ex. 623, p.2, top table.* Avista's average short-term debt has been 3.98 percent; Avista's average preferred debt has been 9.06 percent.

378 The Commission will set a capital structure of 42 percent equity and 58 percent fixed income capital. The fixed income capital shall consist of 45 percent long-term debt, 4 percent short-term debt, and 9 percent preferred stock.

4. Conclusion: Rate of Return

379 The overall rate of return for Avista is set at 9.03 percent, as shown in the following table.

Table 13 Capital Structure — Rate of Return

Table 13 Capital Structure — Rate of Return (Washington Jurisdiction)				
Avista Capital Structure - Rate of Return				
		Capital Structure	Cost	Rate of Return
Equity		42.00%	11.16%	4.69%
Debt				
	Long-term	45.00%	7.45%	3.35%
	Short-term	4.00%	6.39%	0.26%
	Pref. Stk.	9.00%	8.11%	0.73%
		58.00%		
		100.00%		9.03%

380 A return of 9.03% will provide Avista with the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return comparable to other enterprises of corresponding risk.

5. Cost of Equity Adders

381 Avista, through the testimony of Mr. Dukich, requests a 25 basis point markup to the 12 percent return on equity recommended by Dr. Avera. The bonus is sought as a reward for innovative management and strategic initiatives. Mr. Dukich also seeks a higher return on Avista's investment in the Kettle Falls generating station.

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a. Bonus for Innovative Management and Strategic Initiatives

382 Avista seeks a 25 basis point addition to its rate of return, in order to reward the Company for innovative management and strategic initiatives. Mr. Dukich argues that no witness has disputed that Avista has very low rates. According to Mr. Dukich, Avista's low rates cannot be explained exclusively by its hydro base or by the growth characteristics of its customer base. Instead, he argues, they are the consequence of the Company's commitment to "cost containment, efficiency, and innovation."

383 To clarify his initial proposal to add an efficiency incentive to return on equity (ROE), Mr. Dukich points out that, if approved, the 25 basis point incentive would generate $1.28 million in annual revenue, which is one-half of one percent of the $250 million in annual company pro forma revenue. He argues that this incremental revenue would be offset by a one-half of one percent productivity or efficiency improvement. This, he argues, the Company has exceeded in the past and will exceed in the future. Therefore, he argues, the incentive is warranted.

384 Commission Staff does not believe that a markup to the Company's equity return is an appropriate means of rewarding Avista. In Dr. Lurito's view, existing stockholders are already fully compensated by a fair rate of return and an increase in return above that required by rational investors would give existing stockholders a one-time windfall by increasing the stock price. The Commission Staff does not see an equity markup by a commission as an appropriate tool to reward excellent management.

385 Public Counsel also disagrees with the Company's proposal that a 25 basis point adder should be awarded to reward management efficiency, noting that a 25-basis-point adder will cost ratepayers approximately $1.25 million for every year that rates set in this proceeding are in effect. Public Counsel argues that Avista's low electric rates benefit both ratepayers and shareholders. The Company faces minimal risks related to stranded generation costs, due to its low-cost portfolio of generation assets. Public Counsel also argues that Avista has the highest non-production costs per customer of any Northwest investor-owned utility. He believes that Avista's rates are low because it has inexpensive hydropower, and because it serves a slow-growing area.

386 Mr. Dukich objects to characterizations by Mr. Lazar and ICNU that Avista is among the least efficient utilities when judged based on non-power-related costs. He argues

that Mr. Lazar has misused and misrepresented data. Mr. Dukich does not agree that the innovations are due only to past management. He argues that if such improvements are to continue, current management should benefit from the incentive.

Commission Discussion and Decision

387 The Commission sets a reasonable return in a rate proceeding. Once a reasonable return is set, management should seek to earn any "bonus" through efficient operation of the business. The market will reward a better-managed company. It would take truly extraordinary circumstances for the Commission to authorize a bonus above the appropriate range of reasonable returns.

6. Incentive Rate of Return for Kettle Falls Plant

388 The Company built and has operated a wood-fired power plant in NE Washington since 1983. The prudence of this plant was considered in the 1983 Rate Case. *Cause No. U-83-26.* The Commission found at that time that 10 percent of the construction expenses for the plant were imprudent and disallowed their recovery in rates. Prior to that rate case, in 1980, the Legislature enacted RCW 80.28.025, which provides that the Commission shall award a 2 percent increment to rate of return for investments in renewable resources that are cost-effective. Now, in this proceeding, Avista is requesting such a 2 percent incentive for its Kettle Falls plant.

389 The Company argues that the Kettle Falls plant meets the requirements set out in the statute and that the statute compels the Commission to grant the incentive rate of return, because the statute uses the terms "shall adopt policies" and "policies shall include. . . allowing a return on investment. . . of two percent to the rate of return on common equity. . . "

390 According to the Company, its request to receive the 2 percent increment to earnings on investment in Kettle Falls is justified because: 1) the Department of Revenue found the investment to qualify under the statute granting a related tax credit, and 2) the Commission found that 90 percent of the investment in Kettle Falls was prudent. The Company cites passages from the Commission's Order in *Cause U-83-26* to demonstrate Commission acknowledgment that the plant as originally planned and evaluated was the lowest-cost alternative. The Company argues that the latter fact indicates that the Commission found the plant to be the least cost alternative based on

90 percent of its cost and that it is entitled to the bonus return on this figure. The Company represents that these facts are sufficient evidence that the Company deserves the incentive.

391 Commission Staff opposes the Company's request for the 2 percent equity bonus return. According to Staff, the Commission's decision to disallow a portion of the costs for Kettle Falls "indirectly" determined that Kettle Falls is not eligible for the bonus. This conclusion is based on a portion of the order in which the Commission compared the cost of Kettle Falls to the cost of other available resources and found that Kettle Falls cost more. Thus, Staff argues, the plant fails the cost-effectiveness test set out in the statute, because ". . . at the time it was placed in rate base, the Kettle Falls plant was not expected to produce power at a lower cost than similar conventional methods of producing power using fossil fuels." *Staff Brief, p. 7. Emphasis in original.* Staff argues that this test of cost-effectiveness is the proper one because the statute uses the term "at the time it is placed in rate base," and that the statute specifically states that to be cost-effective the plant must ". . . [be] reasonably expected to save, produce, or generate energy at a total incremental system cost per unit of energy delivered . . . " *Id. Emphasis in original.* Therefore, because only 90 percent of the plants cost was allowed in rates, Staff concludes that at the time it was placed in rate base the Kettle Falls plant did not meet the "total" cost test of cost-effectiveness.

392 In addition, the Commission Staff objects that Company representations regarding recent efficiency gains at the plant (output increased from 42 to 50 MW) are irrelevant because the statutory test examines the plant at the time it is put in rate base. Staff contends that improvements in efficiency seventeen years later cannot have motivated the Company's investment in Kettle Falls. According to Staff, "The statute was designed to provide an incentive to companies to build alternative means of power generation if they are more cost-effective than other means. To allow the Company to begin collecting a higher return . . . .long after it was constructed . . . does not meet the purposes for which the statute was enacted." *Id., p. 8.* Finally the Staff rejects the relevance of the Department of Revenue finding.

393 Public Counsel also opposes Avista's request for a Kettle Falls bonus, amplifying the arguments of Commission Staff with more detail. In particular, Public Counsel notes that the Company provides no evidence to demonstrate the cost-effectiveness of the plant at the time it was put in rate base. According to Public Counsel, the

Commission decision in the 1993 rate case to include roughly 90 percent of plant costs in rates may have been appropriate for a prudence test, but cannot be taken as evidence that the plant was cost-effective. He represents that in 1984 the cost of Kettle Falls exceeded that of other alternatives by 25 to 50 percent. Today, according to Public Counsel, the plant generates power at $43.00 per megawatt hour, which is higher than other alternatives. He concludes that the plant does not qualify for the bonus equity return because it was not cost-effective when built, was not cost-effective when entered into rates, and is not cost-effective today.

394 On rebuttal and in its Brief, the Company argues that it is only seeking a bonus return on the 90 percent of the plant found to be prudent (and therefore, Avista claims, cost-effective).

395 For its part, NWEC believes that a higher return on investment should be granted if the Company demonstrates that the Kettle Falls plant meets the criteria established in RCW 80.28.025. However, NWEC does not make its own judgment on whether the criteria are met, and it does not brief this issue. It does argue that the Company can and should take action to further increase the environmental benefits associated with the Kettle Falls Generating Plant by purchasing wood waste only from suppliers who have received certification by the Forest Stewardship Council (FSC). The Company currently receives wood from several suppliers who have received certification from the Sustainable Forestry Initiative (SFI). NWEC does not believe SFI adheres to the level of environmental stewardship that the NWEC considers necessary in a certification program, but that the FSC does. NWEC believes that it would be reasonable for the Company to require its wood waste suppliers to undergo independent third-party certification and encourages the Commission to direct the Company to do so.

Commission Discussion and Decision

396 RCW 80.28.025 provides in relevant part:

> Measures or projects encouraged under this section are those for which... *at the time they are placed in the rate base, are reasonably expected* to save, produce, or generate energy at a total incremental system cost per unit of energy delivered to end use which is less than or equal to the incremental system cost per unit of energy delivered to end use from similarly available conventional energy

> resources which utilize nuclear energy or fossil fuels and which the gas or electric company could acquire to meet energy demand in the same time period. *Emphasis added.*

397 Kettle Falls was placed into rate base in Cause U-83-26.[14] At that time, we made no determination of reasonable expectation of savings under this statute because the matter was not presented in that rate case. As the statute was enacted prior to the 1983 rate case, there is no reason why Avista could not have presented this issue in the earlier rate case. Had Avista raised this issue for our consideration at that time, all parties would have had timely access to relevant information, and the Commission could have made a timely determination of this issue.

398 The statute, appropriately, contemplates granting the incentive no later than the next general rate case following initiation of construction or installation. A longer time interval, in this case seventeen years, neither meets the meaning of the statute nor facilitates any meaningful "incentive" to build an appropriate facility. Therefore, we decline to grant the 2 percent incentive.

F. Cost of Service, Rate Spread, and Rate Design

1. Low-income Customer Issues and Programs

399 The Company made no proposals regarding low-income energy assistance. SNAP made two proposals regarding this issue. First, a rate surcharge of 1 percent of total revenues should be implemented to fund low-income programs. Second, responsibility for the specific design of the low-income interventions should be assigned to a working group charged with developing and presenting the program design to the Commission within a certain time.

400 Both Public Counsel and NWEC support SNAP's proposal. Public Counsel recommends that the Commission direct Avista to engage in a collaborative planning process with stakeholders to develop a low-income assistance filing in time for the onset of the winter heating season. NWEC recommends that Avista's energy efficiency programs to low-income customers be combined with meaningful

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[14] *Washington Utilities and Transportation Commission v. Washington Water Power Co.*, Docket No. U-83-26, Fifth Supplemental Order (1984) (hereinafter cited as "U-83-26").

programs supported by a guaranteed level of investment in low-income energy assistance.

401 Avista does not support SNAP's proposal, as they believe they already spend close to the proposed 1 percent surcharge on their low-income efforts, which are already adequate. The Company states that it already provides aggressive energy and fuel efficiency assistance, as well as specialized customer service dedicated to financially distressed customers. If, however, a collaborative process is ordered by this Commission, the Company recommends that it be a state-wide process for the purpose of examining low-income issues, as the same may be affected by existing Commission collection and disconnection rules and practices.

Commission Discussion and Decision

402 The Commission values and encourages continued dialogue among the various parties with regard to low-income energy efficiency and assistance efforts. However, RCW 80.28.068 grants no latitude to the Commission to order such rates in the absence of a company request. The statute provides:

> *Upon request by an electrical or gas company*, the commission may approve rates, charges, services, and/or physical facilities at a discount for low-income senior customers and low-income customers. Expenses and lost revenues as a result of these discounts shall be included in the company's cost of service and recovered in rates to other customers. *Emphasis supplied.*

403 Therefore, the Commission cannot act on SNAP's proposed one percent wires charge and collaborative process. In our view, the legislature has granted us authority to order a surcharge only if the Company requests it.

2. Cost of Service Studies

404 Both Commission Staff and Public Counsel agree that the Company's gas cost of service study is generally consistent with prior Commission decisions. Staff, however, has concerns over allocation of expenses for demonstrating and selling and over the allocation of some administrative and general (A&G) costs.

405 Avista's electric cost of service study departs somewhat from the method previously approved by the Commission for Puget Sound Power & Light (Puget) *(Docket No. UE-920499)*. The main differences are the definition of peak and how administrative and general (A&G) expenses are handled. Rather than allocating A&G costs based on other factors, Avista assigns A&G costs directly where possible. Where they could not be directly assigned, the Company places them in the category of "Other," and allocates 40 percent to energy (annual kWh) and 60 percent to number of customers. The Company arrived at this factor "intuitively from a sense that most general costs . . . are impacted by the number of transactions involved." *Ex 460, 11.* Avista believes its approach is an improvement over the 1992 Puget method because of the "functional direct assignment" of A&G costs, and because the definition of peak is tailored to the operational characteristics of Avista rather than using assumptions relevant to Puget. The Company requests that the Commission explicitly approve its cost of service methodology in order to provide direction that can be used consistently over time for rate spread and rate design. *Avista Brief, 97.*

406 Commission Staff believes that Avista's electric cost of service study is acceptable and the results are generally reasonable. Staff recommends, however, that the Commission specifically state in its order that it is not accepting the results of any particular cost of service study. *Staff Brief, 101.* That is, use of a study's results should not be taken as approval of a precedent-setting methodology.

407 Public Counsel argues that there is no valid electric cost study in this proceeding for three reasons: (1) Avista's A&G approach has never before been considered, is contrary to both the 1993 PSE precedent and the Company's own gas study, and assigns about two-thirds of the A&G costs to the residential class, which is "vastly out of proportion to the share of company sales and revenues which this class represents." *Public Counsel Brief, 73.* (2) Avista witness Tara Knox did not update her study when the Company filed its rebuttal testimony, which included, for instance, a significant change in depreciation rates. (3) Several adjustments proposed by Commission Staff and Public Counsel would not affect classes uniformly. The Commission proceeded deliberately in its 1992 Puget decision, first explicitly deciding the cost allocation methodology, then deciding the revenue requirement, then directing Puget to re-run the cost of service model with the approved methods and costs, and finally shifting rates in accordance with the results. In this case, Public Counsel argues, there is neither a methodological record nor sufficient time to do this multi-step process.

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Commission Discussion and Decision

408 The Company is correct in principle: Direct assignment of costs is preferable to allocating costs based on an indicator. However, the Company does not assign all A&G costs directly. Many A&G costs are assigned to the category "Other" and subsequently allocated 40%/60% to energy/customers based on the Company's intuition. This is not direct assignment, but allocation. Moreover, this is allocation based on an entirely subjective allocation factor. For this reason, there is not a sufficient basis in the record to specifically approve the Company's A&G approach. No parties objected to the use of a company-specific peak usage allocator, which would be based on the peak usage on Avista's system. The Commission agrees that the peak usage patterns of each unique company are appropriately used in that company's cost of service study.

3. Electric Rate Spread

409 Avista's proposed electric rate spread would move each customer class one-third of the way toward "unity," i.e., where revenues from each schedule contribute proportionately to the company's rate of return. Avista recommends that a one-third movement toward unity is the minimum that the Commission should consider in this case, regardless of what overall revenue requirement is granted. Public Counsel objects to Avista's proposal to move toward unity on several grounds, most of them based on objections to the electric cost of service study presented above: the study was not updated to reflect changes during rebuttal; by changing the A&G cost allocation, the cost of service study is not a reasonable definition of "unity"; the Commission has consistently rejected proposals to move mechanically toward cost of service results; and in the absence of a valid cost of service study, a "uniform percentage" increase is the accepted practice (although Public Counsel joins in a recommendation that would provide a lower percentage increase or a higher percentage decrease to the commercial class). Commission Staff recommends that all classes of customers should shoulder some share of a rate increase, and likewise should benefit from any ordered decrease in rates.

410 Commission Staff, Public Counsel, and ICNU witnesses sponsored joint testimony on electric rate spread, recommending that commercial customers receive a smaller than average rate hike (or a larger than average rate decrease) and that all other classes face

the same percentage change. *Ex. 675.* Noting the almost unprecedented nature of such joint testimony and agreement, Public Counsel recommends the Commission give very substantial weight to it. Avista responds that the Joint Testimony would be a move in the right direction, but would not move as far as the Company's proposal. Avista claims that its commercial and industrial customers classes whose rates are higher than cost of service are the customers that create the biggest competitive concerns for the Company.

Commission Discussion and Decision

411 As a general principle, the Commission agrees that it is reasonable to move each customer class toward the cost of providing it with service. With a disputed cost of service study, however, we cannot take the Company's determination of "unity" as an absolute goal. This Commission has never mechanically applied the results of a cost of service study, but exercises judgment in each determination. The Joint Testimony offers movement toward the Company's goal; it recommends larger than average decreases for commercial customers. We also note that ICNU, which represents large industrial customers, is a sponsor of the joint testimony; we give weight to its opinion of an appropriate spread of rates to industrial customers. The revenue requirement decrease as a result of this order should be spread according to the Joint Testimony's rate reduction formula. The problem with going further toward unity, as Avista urges, is that Avista's underlying cost of service study is not sufficiently rigorous to rely on it for that purpose at this time.

G. Electric Rate Design

412 Avista proposes two major changes in rate design: 1) increasing the basic monthly charge from $3 to $5, and 2) reducing the number of rate blocks from three to two.

1. Monthly Charge

413 Avista claims that the basic customer charge should recover fixed costs of a service line, meter, meter reading, and billing. The cost of service study shows a fully allocated residential cost of $14.70 a month, with many demand and customer costs recovered through the energy component of the rate. For comparison, PSE's monthly charge is $5.28. Commission Staff recommends changing only the energy component, not the fixed charge component, of existing rates, as the most appropriate

way to give effect to rate changes, arguing that it would be confusing to customers if basic charges increase while other charges decrease.

414 Public Counsel admits that fixed customer costs exceed the current $3 a month charge, but believes that increasing them 60 percent would constitute an unfair increase to small-use customers and would be inconsistent with Commission policy. If the Commission orders a rate increase of five percent or more, Public Counsel would support a portion of that increase being collected through the customer charge, up to $3.75 a month. If rates increase by less than 2 percent, the customer charge should remain unchanged.

415 Avista replies that Public Counsel witness Mr. Lazar's errata testimony showed a monthly cost figure of $4.59 a month. Mr. Lazar's method of computing the monthly charge assumed that 50 percent of meter reading and billing costs are usage related. Without this adjustment, the basic charge would be $5.71 a month.

Commission Discussion and Decision

416 We accept as reasonable the Company's proposal to increase the monthly charge to $5.00. While the Commission is sympathetic to the plight of small-usage and low-income customers, the Company is entitled to recover the fixed cost of serving customers, and the most appropriate mechanism to do this is a fixed charge. As noted above, we reject Public Counsel's bi-monthly meter reading adjustment.

2. Two-block Rate Structure

417 Avista has proposed "flattening" its residential rate design from three usage blocks to two. Because many fixed costs are recovered through energy charges in the third block, and because usage in the tail block is weather sensitive, the Company claims that a three-block rate puts it at risk of under-recovering its revenue requirement. The current rate structure was put in place in 1981 to send a price signal about the higher incremental cost of new generating resources, but it no longer represents the incremental cost of energy, according to Avista.

418 In reply, Public Counsel provides background about when and why the Commission adopted the three-block rate structure. *Public Counsel Brief, 78-79.* Based on this history, Public Counsel argues that the Company's justification for eliminating the

third block is "utterly inadequate to support a major policy change of this type." Mr. Lazar provided two separate analyses that justify the three-block rate design, one based on the concept of "baseline" rates adopted in U-78-05 (i.e., low-cost hydropower should be considered as serving the first "baseline" block of service), and one based on residential energy usage (i.e., electric heat is sporadic and "peaky," while lights and appliance usage is stable throughout the day and year).

419 NWEC concurs in Public Counsel's recommendation and analysis, since the three-block rate structure sends an appropriate signal to conserve energy. Although Avista argues that low-income customers without options may be hurt, NWEC believes all customer classes should reduce unnecessary energy consumption, and recommends developing programs targeted at these low-income heating customers. *NWEC Brief, 4-6.*

420 Avista's rebuttal claims that Mr. Lazar makes erroneous assumptions, first about how resources are used to serve customers (in fact, hydropower is used for variable weather-sensitive load); and second, that space-heat customers have higher distribution costs than those without electric heat (most distribution costs are fixed and would be relatively the same whether or not a customer used electric heat). Public Counsel replies that these assertions seem to suggest the illogical conclusion that it is cheaper to serve peak demand than off-peak, and that the Company's rate design proposal ignores any sort of cost-based principle.

Commission Discussion and Decision

421 We will retain the three-block rate structure. This rate design was developed from a more thorough record than the one here, and there is insufficient evidence in this proceeding to depart from it. The Company suggests that the three-block rate design no longer represents the incremental cost of power, but offers no incremental cost study in the record to support its position. Given recent energy market developments, including higher-priced natural gas which translates into higher prices for gas-fired electricity generation, the incremental cost of additional energy resources is unknown at this time. Avista is welcome to bring this proposal forward in a different proceeding, along with better justification.

3. Electric Tariff Rider

422 The Company proposes to maintain the level of the electric demand side management (DSM) tariff rider at 1.54 percent of retail revenues. The Commission finds this acceptable. However, if the balance in the tariff rider fund is not reduced to a reasonable level[15] by mid-year 2001, the Company must file a rider rate adjustment that more closely matches its actual DSM program expenditures. If the energy efficiency program expenditures exceed tariff rider collections in the future, the Company may not collect interest on the negative balance; the Company must bear the risk of undercollection of funds through the tariff rider; because the Company, not its customers, manages the energy efficiency program expenditures.

H. Natural Gas Rate Spread

423 Commission Staff, Public Counsel, and NWIGU sponsored joint testimony on gas rate spread, agreeing that any increase in natural gas rates should be spread among classes (other than schedules 131 and 148) on an equal percentage of margin basis. All customer classes fall withing a narrow range with respect to revenue versus average rate of return. Avista agrees with the joint rate spread proposal. *Avista Brief, 101.* We accept the joint proposal.

I. Natural Gas Rate Design

424 There are two areas of disagreement on natural gas rate design: 1) The level of the monthly charge, and 2) rate structures for transportation customers.

1. Gas - Monthly Customer Charge

425 Avista proposes increasing the residential basic monthly charge from $4 to $5 a month, which would recover the cost of meters, meter reading, billing, and service lines (i.e., the line that connects a customer's house to the gas main). The Company claims this would recover less than 20 percent of gas service costs. Commission Staff advocates changing the customer charge by the same percentage as the overall

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[15] Defined by Commission Staff as approximately one to one and one-half months' revenues from the tariff rider, or a balance under $450,000.

increase. Public Counsel recommends keeping the current $4 per month basic charge, claiming that customer costs are only $2.82 a month.

426 There are two main differences between Avista's and Public Counsel's calculations: whether service lines are included as a customer cost or not, and whether Avista uses monthly or bimonthly meter reading.

427 Public Counsel argues that the expense of service lines should not be included because he believes that the party who pays for the service line (company or customer), and how much is paid, varies with the amount of usage expected from the new customer. Public Counsel bases this argument on the fact that the Avista's line-extension tariff provides for the Company to pay an increased amount of the cost of the service line to the customer who uses more gas appliances. Public Counsel claims that a small-use customer who has paid out-of-pocket for the line that connects service should not have to pay a component of a monthly customer charge that is designed to recover the cost of the service line hook-up for those customers who have not paid directly (because Avista has paid for their service lines because they use many gas appliances). Public Counsel argues that the service line cost should be viewed as usage-related rather than customer related, and that its cost should be spread by a usage-based allocator. Public Counsel also makes the same arguments regarding bimonthly vs. monthly meter reading that we discussed in the electric portion of the order.

428 Avista replies that Public Counsel would be correct only if the Company has significant numbers of low-use gas customers and all gas service line costs were recovered through the basic charge, neither of which is true. Avista claims residential customers requesting new natural gas service do so primarily to heat their homes, and, because of the allowance for gas heat usage in the line extension tariff, do not pay up-front for service line extensions.

Commission Discussion and Decision

429 We accept the Company's proposal to increase the gas monthly charge to $5 per month. Avista has provided support for this amount. As an added advantage, a five dollar gas basic charge provides symmetry with the electric basic charge, allowing customers to make easier comparisons when deciding which energy source to choose. We rejected Public Counsel's arguments for bimonthly meter reading, above. Public

Counsel's argument about double-collecting line extension funds might be true in theory and under different circumstances, but is not persuasive in reality.

2. Gas Transportation Rate Structure

430 For gas transportation customers, Avista recommends replacing a two-block rate with a four-tier structure, consistent with other gas companies' transportation rate design. Monthly charges for transportation customers would increase to $200 per month, from the present $164.88, which matches the monthly charge for the other large customer class (i.e., banded rates).

431 Commission Staff witness Jim Russell offered three rate design goals: (1) keep the break-even points between Schedules 101, 111, and 121 consistent with Avista's rate design proposal, (2) make interruptible service (Schedule 131) more attractive to customers who might qualify, and (3) redesign transportation service (Schedule 146) to include more rate blocks, similar to Avista's proposal. Mr. Russell set the first block at a level that would produce margin revenue close to the margin revenue produced under Schedule 121 at the 20,000 therm level.

432 NWIGU witness Mr. Schoenbeck suggests that the Company's primary reason for proposing a redesign of Schedule 146 is to avoid "schedule-shifting," the possibility of customers changing from sales (Schedule 121) to transportation (Schedule 146) service. NWIGU asserts that there is little evidence to support this premise. Mr. Schoenbeck proposes adding a fifth rate block to Schedule 121 to address the Company's concern over margin loss from migration to Schedule 146, and to address the declining cost aspect of providing delivery service to a sales customer.

433 Avista agrees with Commission Staff's proposed four-block rate design for interruptible customers (Schedule 131). The Company supports Staff's proposed five-block rate design for transportation customers (Schedule 146), but takes exception to NWIGU's proposal to reduce rates for the first two blocks under Schedule 146. NWIGU's proposed addition of a fifth block to Schedule 121 would not be necessary if Staff's higher rate levels are established for the first two blocks under Schedule 146. Public Counsel supports NWIGU's proposals because they will mitigate schedule shifting.

Commission Discussion and Decision

434 We accept NWIGU's proposed rate design for Schedules 146 and 121. The schedule 146 design uses the same number of rate blocks as Commission Staff. We agree with Avista and Staff that it is time to restructure rates for these customers. NWIGU's proposal will still accomplish this goal, but with less drastic increases for an important commercial customer sector. The fact that this design is more acceptable to customers and public counsel, gives weight to this recommendation.

3. Gas Tariff Rider

435 Avista established a gas tariff rider in 1994. *Docket Nos. UG-941376, UG-941378, Dec. 28, 1994.* The tariff rider mechanism was set at a level designed to collect the amount needed to fund Avista's then-available gas conservation measures. As the price of gas fell, the Company's gas conservation program stopped funding conservation measures. Avista, however, kept the tariff rider in its tariff, but funded it at a level of "zero." NWEC recommends increasing the natural gas tariff rider to its former level of 0.52 percent, in order to provide funds to be used to capture potential conservation opportunities that will be cost-effective for ratepayers.

436 The Company proposes to maintain the level of the natural gas tariff rider at 0.0 percent of retail revenues, and proposes revisiting the possibility of increasing the tariff rider (in light of increasing gas prices) during its Integrated Resource Planning (IRP) process. NWIGU urges the Commission to reject the call for the immediate imposition of a 0.52 percent tariff rider, since the Company plans to reevaluate the viability of offering natural gas energy-efficiency programs after it submits its Integrated Resource Plan to the Commission.

Commission Discussion and Decision

437 The Commission agrees with Avista and NWIGU that the Company should maintain the natural gas tariff rider in its tariff, but that it should not begin collecting monies through the tariff until after consideration of gas tariff rider funding in its IRP process, now underway.

K. Public Participation

438 The Commission held a public hearing in Spokane, Washington, on April 20, 2000, to receive testimony from members of the public. The Commission also entered Exhibit 744 into the record for illustrative purposes. This exhibit is a collection of public letters sent to the Commission and Public Counsel regarding Avista's rate increase requests.

439 In his testimony, Avista CEO Tom Matthews made the assertion that Avista's customers understood why the Company needed the requested rate increase, and went on to opine that the low turnout at the Spokane hearing was reflective of low public concern. *TR 1989.*

440 Public Counsel takes exception to Mr. Matthews' understanding of customers' reactions to the rate increase request. While agreeing that the public hearing turnout was low, Public Counsel notes that of those who did attend, and who spoke, all opposed the rate increase.

441 Public Counsel has reviewed the comment letters received up through July 21, 2000. He notes that, of the 250 letters or other written comments contained in the exhibit, 237 oppose Avista's requested rate increase.

442 Many of the customers raise the very concerns raised by the parties to this rate case, including issues relating to executive salaries, to the quality of management and service of the Company, and to the impact of unregulated activities on Avista.

III. CONCLUSION

443 The Commission has determined appropriate rates for Avista by determining Avista's test year net operating income, approving certain adjustments to the test year results, determining Avista's rate base, determining a fair rate of return for Avista to earn on that rate base, and finally determining Avista's current revenue requirement. We also find the end result of these determinations to be fair, just, reasonable, and sufficient. In determining a fair return for Avista, the Commission has already examined the safety of the result, and has determined that Avista has sufficient coverage to maintain its ability to raise capital at reasonable costs. The Commission has ordered a refund of the customers' share of Centralia sale proceeds, and return of the proceeds of the

rate year buydown of the PGE contract, and Avista has received the dollars in hand which it needs to carry out our instructions. The end result of this rate proceeding is fair to Avista.[16]

Table 14 Electric Revenue Requirement

Table 14 Electric Revenue Requirement (Washington Jurisdiction) ($000)		
Electric Revenue Requirement Calculation	**NOI**	**Rate Base**
Per Books	$61,733	$736,129
Total Non-contested adjustments	(6,543)	(76,732)
Total Contested Adjustments	(3,111)	(106,081)
Pro Forma Results of Operation	52,079	553,316
NOI (Excess)/Deficiency	(2,115)	
Conversion Factor	0.620919	
Revenue (Excess/Deficiency	**(3,406)**	
Pro forma results of rates	49,964	
Authorized Rate of Return	9.03%	

Table 15 Gas Revenue Requirement

Table 15 Gas Revenue Requirement (Washington Jurisdiction) ($000)		
Gas Revenue Requirement Calculation	**NOI**	**Rate Base**
Per Books	$8,482	$125,541
Total non-contested adjustments	1,249	(5,622)
Total contested adjustments	67	0
Pro forma Results of Operation	9,798	119,919
NOI (Excess)/Deficiency	1,031	
Conversion Factor	0.616505	
Revenue (Excess/Deficiency	**1,672**	
Pro forma results of rates	10,829	
Authorized Rate of Return	9.03%	9.03%

[16] See *Duquesne Light Company v. Barasch*, 488 U.S. 299, 310, 312, 109 S.Ct. 609, 102 l. Ed. 2d 646, 98 P.U.R. 4th 253 (1989)

444 Based on the entire record and the file in this proceeding, the Commission makes the following findings of fact and conclusions of law.

IV. FINDINGS OF FACT

445 Having discussed above in detail both the oral and the documentary evidence received in this proceeding concerning all material matters, and having stated the Commission's findings and conclusions upon contested issues and the Commission's reasons and bases therefor, the Commission now makes and enters the following summary of those facts. Those portions of the preceding detailed findings pertaining to the ultimate findings stated below are incorporated into the ultimate findings by reference.

446 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including electric companies.

447 (2) On October 22, 1999, Avista Corporation ("Avista" or "the Company") filed certain tariff revisions designed to effect general increases in its rates for electric and natural gas services in Dockets No. UE-991606 and UE-991607, respectively.

448 (3) The Company's letter of transmittal indicates that the cumulative effect of the tariff filings would be to increase annual electricity revenues by $26.25 million and natural gas revenues by $4.9 million. The Commission, by orders entered November 30, 1999, suspended the operation of the tariff revisions pending hearing or hearings concerning such charges and the justness and reasonableness thereof. The two matters were consolidated.

449 (4) Additional notice was given on April 28, 2000, that the Commission would consider whether existing rates are just, fair, reasonable, and sufficient, and in the public interest.

450 (5) During the proceedings on July 13, 2000, the Commission received and considered a Stipulation entered into by Avista and Commission Staff regarding use of an appropriate water record for normalizing hydroelectric generation. Exhibit 740 is the Stipulation. The Stipulation should be approved and adopted.

451 (6) The appropriate test period is the most recent 12-month period for which income statements and balance sheets are available. The test period is used for investigation of the Company's electricity and natural gas operations for the purposes of this proceeding. The appropriate test year in this proceeding is calendar year 1998.

452 (7) The Company's electric results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable events is $52,079,000.

453 (8) Avista should file a power cost case no later than December 1, 2001, in which it provides an improved dispatch model and more accurate power costs. $8,664,576 of the rates approved in this order are temporary amounts that will expire on November 30, 2002, unless extended by Commission order. We expect that the rates resulting from Avista's power cost filing will be set by an order entered on or before October 31, 2002, and that a compliance filing setting a new level of rates will be effective before November 30, 2002. The temporary amount is $8,664,576, which is based on the pro forma power supply adjustment.

454 (9) The Company's natural gas results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable events is $9,798,000.

455 (10) The rate base represents the net book value of assets which are provided by investors' funds and which are used and useful in providing utility service to the public. The appropriate electricity rate base, which is derived from the balance sheets of the test period, as adjusted for increases and decreases in investment, is $553,316,000.

456 (11) The rate base represents the net book value of assets which are provided by investors' funds and which are used and useful in providing utility service to the public. The appropriate natural gas rate base, which is derived from the balance sheets of the test period, as adjusted for increases and decreases in investment, is $119,919,000.

457 (12) The appropriate rate of return the Company is authorized to earn on its electricity and natural gas rate base is 9.03 percent.

458 (13) The rates proposed by Avista's as-filed tariff revisions that are the subject of the Commission's complaint and inquiry in this proceeding, if implemented, would not be just and reasonable.

459 (14) Avista's currently effective electricity rates yield higher than reasonable compensation to Avista for the services rendered. Avista's electricity rates should be lowered by $3,406,000.

460 (15) Avista's currently effective natural gas rates do not yield reasonable compensation to Avista for the services rendered. Avista's current natural gas rates should be increased by $1,672,000.

461 (16) The customer charge for Avista's residential customers (electric and natural gas) should be increased to $5 per month.

462 (17) The number of residential rate blocks for residential electric customers should not be changed.

463 (18) The allocation of the rate decrease for electric customers should be spread by an equal percentage to all classes among the Company's ratepayers.

464 (20) The rates that result from this order together are just, reasonable, and compensatory.

465 (21) The rates that result from this order are neither unduly preferential nor discriminatory.

V. CONCLUSIONS OF LAW

466 Having discussed above in detail all matters material to our decision, and having stated general findings and conclusions, the Commission now makes the following summary conclusions of law. Those portions of the preceding detailed discussion that state conclusions pertaining to the ultimate decisions of the Commission are incorporated by this reference.

467 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and all parties to, these proceedings. *Title 80 RCW.*

468 (2) Avista Corporation in Washington State is a public service company as defined in RCW 80.04.010, and as that term otherwise may be used in Title 80 RCW.

469 (3) A rate increase of $1,672,000 for Avista's natural gas operations will result in rates that are fair, just, reasonable, and sufficient.

470 (4) A rate decrease of $3,406,000 for Avista's electricity operations will result in rates that are fair, just reasonable, and sufficient.

471 (5) $8,664,576 of Avista's electricity revenue requirement is temporary, and will be removed from rates on November 30, 2002. Avista must file a power cost case no later than December 1, 2001, to set a new rate level for power and capacity costs.

472 (6) The Commission should retain jurisdiction over the subject matter and the parties to effectuate the provisions of this Order. *Title 80 RCW.*

VI. ORDER

473 THE COMMISSION ORDERS:

474 (1) The Commission has jurisdiction over the subject matter and the Parties to these proceedings.

475 (2) The proposed tariff revisions filed by Avista on October 22, 1999, and suspended by prior Commission order, are rejected.

476 (3) The Hydo-Normalization Stipulation is approved, adopted, and made part of this Order.

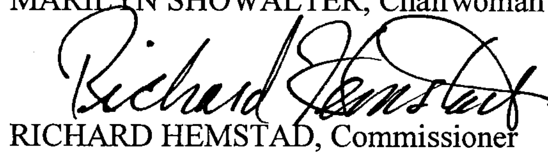
477 (4) Avista Corporation is authorized and required to make appropriate compliance filings and such other filings as are necessary to effectuate the terms of this Order no later than October 13, 2000. The Commission Staff shall examine the compliance filing, and shall provide its analysis of whether the compliance filing meets the requirements of this order no later than October 23, 2000. Other parties should examine the compliance filing, and may provide comments to the Commission by October, 23, 2000.

478 THE COMMISSION ORDERS FURTHER That it retains jurisdiction over the subject matter and the Parties to effectuate the provisions of this Order.

DATED at Olympia, Washington, and effective this 29th day of September, 2000.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARILYN SHOWALTER, Chairwoman



RICHARD HEMSTAD, Commissioner

WILLIAM R. GILLIS, Commissioner

NOTICE TO PARTIES: This is a final Order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this Order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).

APPENDIX A

PGE Contract Test Year Buydown: Rate Base Adjustment

	System	Washington
Contract Buydown Revenue	$143,400,000	$96,063,660
Interest over 21 months (a)	21,205,275	14,205,414
Amortization 21 mos	(13,900,000)	(9,311,610)
Total Net Funds 10/1/2000	150,705,275	100,957,464
Balances Eliminated:		
Wood Power Contract Buyout	(5,046,868)	(3,380,897)
Nez Perce Up-front Payment	(2,402,800)	(1,609,636)
Subtotal		95,966,931
Rate Base Reductions		
Rate Base Reduction Equal to Rathdrum Lease Balance		(37,030,583)
DSM Weatherization Balance		(21,407,750)
Buydown Balance Residual: Reduce Rate Base Amortized over 8 years.		(37,528,598)
Subtotal		(95,966,931)
8-year annual amortization of PGE Buydown Balance Residual		4,691,075
Annual DSM amortization		2,939,000
2001 half-year amortization		2,345,537
Total Rate Base reduction		**$93,621,394**
NOI effect of amortization		**$4,959,549**

(a.) Interest calculated at 8.45% Note Rate in Exhibit 225

APPENDIX B
GOVERNING STATUTES AND RULES

The following statutory provisions and rules establish standards that govern the Commission's determinations in this general rate proceeding:

RCW 80.01.040 General Powers and Duties of Commission

The utilities and transportation commission shall:

(3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, electrical companies . . .

RCW 80.04.130 Suspension of tariff change

(1) Whenever any public service company shall file with the commission any schedule, classification, rule or regulation, the effect of which is to change any rate, charge, rental or toll theretofore charged, the commission shall have power, either upon its own motion or upon complaint, upon notice, to enter upon a hearing concerning such proposed change and the reasonableness and justness thereof, and pending such hearing and the decision thereon the commission may suspend the operation of such rate, charge, rental or toll for a period not exceeding ten months from the time the same would otherwise go into effect, and after a full hearing the commission may make such order in reference thereto as would be provided in a hearing initiated after the same had become effective. . . .

(2) At any hearing involving any change in any schedule, classification, rule or regulation the effect of which is to increase any rate, charge, rental or toll theretofore charged, the burden of proof to show that such increase is just and reasonable shall be upon the public service company.

RCW 80.04.150 Remunerative rates cannot be changed without approval

Whenever the commission shall find, after hearing had upon its own motion or upon complaint as herein provided, that any rate, toll, rental or charge which has been the subject of complaint and inquiry is sufficiently remunerative to the public service company affected thereby, it may order that such rate, toll, rental or charge shall not be changed, altered, abrogated or discontinued, nor shall there be any change in the classification which will change or alter such rate, toll, rental or charge without first obtaining the consent of the commission authorizing such change to be made.

RCW 80.04.250 Valuation of public service property

The commission shall have power upon complaint or upon its own motion to ascertain and determine the fair value for rate making purposes of the property of any public service company used and useful for service in this state and shall exercise such power whenever it shall deem such valuation or determination necessary or proper under any of the provisions of this title. In determining what property is used and useful for providing electric, gas, or water service, the commission may include the reasonable costs of construction work in progress to the extent that the commission finds that inclusion is in the public interest.

The commission shall have the power to make revaluations of the property of any public service company from time to time.

The commission shall, before any hearing is had, notify the complainants and the public service company concerned of the time and place of such hearing by giving at least thirty days' written notice thereof, specifying that at the time and place designated a hearing will be held for the purpose of ascertaining the value of the company's property, used and useful as aforesaid, which notice shall be sufficient to authorize the commission to inquire into and pass upon the matters designated in this section.

RCW 80.16.020 Dealings with affiliated interests--Prior filing with commission required--Commission may disapprove.

Every public service company shall file with the commission a verified copy, or a verified summary if unwritten, of a contract or arrangement providing for the furnishing of management, supervisory[,] construction, engineering, accounting, legal, financial, or similar services, or any contract or arrangement for the purchase, sale, lease, or exchange of any property, right, or thing, or for the furnishing of any service, property, right, or thing, other than those enumerated in this section, hereafter made or entered into between a public service company and any affiliated interest as defined in this chapter, including open account advances from or to the affiliated interests. The filing must be made prior to the effective date of the contract or arrangement. Modifications or amendments to the contracts or arrangements with affiliated interests must be filed with the commission prior to the effective date of the modification or amendment. Any time after receipt of the contract or arrangement, the commission may institute an investigation and disapprove the contract, arrangement, modification, or amendment thereto if the commission finds the public service company has failed to prove that it is reasonable and consistent with the public interest. The commission may disapprove any such contract or arrangement if satisfactory proof is not submitted to the commission of the cost to the affiliated

interest of rendering the services or of furnishing the property or service described in this section.

RCW 80.28.010 Duties as to rates, services, and facilities

(1) All charges made, demanded or received by any gas company, electrical company or water company for gas, electricity or water, or for any service rendered or to be rendered in connection therewith, shall be just, fair, reasonable and sufficient.

(2) Every gas company, electrical company and water company shall furnish and supply such service, instrumentalities and facilities as shall be safe, adequate and efficient, and in all respects just and reasonable.

(3) All rules and regulations issued by any gas company, electrical company or water company, affecting or pertaining to the sale or distribution of its product, shall be just and reasonable. . . .

RCW 80.28.020 Commission to fix just, reasonable, and compensatory rates.

Whenever the commission shall find, after a hearing had upon its own motion, or upon complaint, that the rates or charges demanded, exacted, charged or collected by any gas company, electrical company or water company, for gas, electricity or water, or in connection therewith, or that the rules, regulations, practices or contracts affecting such rates or charges are unjust, unreasonable, unjustly discriminatory or unduly preferential, or in any wise in violation of the provisions of the law, or that such rates or charges are insufficient to yield a reasonable compensation for the service rendered, the commission shall determine the just, reasonable, or sufficient rates, charges, regulations, practices or contracts to be thereafter observed and in force, and shall fix the same by order.

RCW 80.28.025 Encouragement of energy cogeneration, conservation, and production from renewable resources--Consideration of water conservation goals.

(1) In establishing rates for each gas and electric company regulated by this chapter, the commission shall adopt policies to encourage meeting or reducing energy demand through cogeneration as defined in RCW 82.35.020, measures which improve the efficiency of energy end use, and new projects which produce or generate energy from renewable resources, such as solar energy, wind energy, hydroelectric energy, geothermal energy, wood, wood waste, municipal wastes, agricultural products and wastes, and end-use waste heat. These policies shall include but are not limited to allowing a return on investment in measures to improve the efficiency of energy end

use, cogeneration, or projects which produce or generate energy from renewable resources which return is established by adding an increment of two percent to the rate of return on common equity permitted on the company's other investment. Measures or projects encouraged under this section are those for which construction or installation is begun after June 12, 1980, and before January 1, 1990, and which, at the time they are placed in the rate base, are reasonably expected to save, produce, or generate energy at a total incremental system cost per unit of energy delivered to end use which is less than or equal to the incremental system cost per unit of energy delivered to end use from similarly available conventional energy resources which utilize nuclear energy or fossil fuels and which the gas or electric company could acquire to meet energy demand in the same time period. The rate of return increment shall be allowed for a period not to exceed thirty years after the measure or project is first placed in the rate base.

(2) In establishing rates for water companies regulated by this chapter, the commission may consider the achievement of water conservation goals and the discouragement of wasteful water use practices.

RCW 80.28.068 Rates--Low-income customers. Upon request by an electrical or gas company, the commission may approve rates, charges, services, and/or physical facilities at a discount for low-income senior customers and low-income customers. Expenses and lost revenues as a result of these discounts shall be included in the company's cost of service and recovered in rates to other customers.

WAC 480-09-310 Filing requirements--Definition. Provides in relevant part:

(1) For the purposes of WAC 480-09-300 through 480-09-335 only, a general rate increase filing is the request by any company regulated by the commission under Title 80 and chapters 81.77 and 81.108 RCW for an increase in rates which meets one or more of the following criteria:

(a) The amount requested would increase gross annual revenue of the company from activities regulated by the commission by three percent or more.

(b) Tariffs are restructured such that the gross revenue provided by any customer class would increase by three percent or more.

(c) The company requests a change in its authorized rate of return on common equity or capital structure.

. . .

(2) The following proceedings shall not be considered general rate increases for companies regulated under Title 80 RCW even though the revenue requested may exceed three percent of the company's gross annual revenue from Washington regulated operations: Periodic rate adjustments for electric utilities as may be authorized by the commission; natural gas tracking increases; emergency or other short-notice increases caused by disaster or weather-related conditions unexpectedly increasing a public service expense; rate increases designed to recover governmentally-imposed increases in costs of doing business such as changes in tax laws or ordinances; or other increases designed to recover increased expenses arising on short-notice and beyond the public service company's control.

WAC 480-09-330 Filing requirements--General rate increases. Provides in relevant part:

General rate increase filings for utility companies shall include, at a minimum, the following information:

(1) Twenty copies of all testimony and exhibits which the company intends to present as its direct case if the filing is suspended and a hearing held.

(a) The filing shall also include three copies of supporting work papers. If the testimony, exhibits or work papers refer to a document, including but not limited to a report, study analysis, survey, article or decision, that document shall be provided as a work paper unless it is a reported court or agency decision, in which case the reporter citation shall be provided in the testimony. If the document is voluminous it need not be provided with the filing but shall be made available upon request.

(b) The filing shall also include one copy of the testimony, exhibits, and work papers, in an electronic format or formats authorized by the secretary of the commission for the filing, for use in IBM-compatible computers. Material that has not been produced under the company's direction and control and is not available to it in electronic format, such as generally available copyrighted published material, need not be provided in electronic format.

(c) The filing shall also include three copies of the tariff sheets in legislative format, striking through any material that is to be deleted or replaced and underlining any material to be inserted.

(2) To the extent it is not included in the testimony or exhibits, the following information shall be included in the work papers:

(a) A detailed portrayal of the development of the company's requested rate of return.

(b) A detailed portrayal of restating actual and pro forma adjustments which the company proposes, specifying all relevant assumptions, and including specific references to charts of accounts, financial reports, etc. If the company proposes to calculate an adjustment in a manner differing from the method that the commission most recently accepted or authorized for the company, it shall also present a work paper demonstrating how the adjustment would be calculated under the methodology previously accepted by the commission, and a brief narrative describing the change. Acceptance of a settlement does not constitute acceptance of underlying methodology unless the order accepting the settlement does so specifically.

(i) Restating actual adjustments are defined as those adjustments which adjust the booked operating results for any defects or infirmities which may exist in actual recorded results which can distort test period earnings. Restating actual adjustments are also used to adjust from an as-recorded basis to a basis which is acceptable for rate making. Examples of restating actual adjustments are adjustments to remove prior period amounts, to eliminate below-the-line items which were recorded as operating expenses in error, to adjust from book estimates to actual amounts, and to eliminate or to normalize extraordinary items which have been recorded during the test period.

(ii) Pro forma adjustments are defined as those adjustments which give effect for the test period to all known and measurable changes which are not offset by other factors. The filing shall identify dollar values and underlying reasons for each of the proposed adjustments.

(c) A detailed portrayal of revenue sources during the test year and a parallel portrayal, by source, of the changes in revenue produced by the filing, including an explanation of the derivation of the changes.

(d) If the public service company has not achieved its authorized rate of return, an explanation as a policy statement of why it has not and what the company is doing to improve its earnings in addition to its request for increased rates.

(e) A representation of the actual rate base and results of operation of the company during the test period, calculated in the manner used by the commission to calculate the company's revenue requirement in the commission's most recent order granting the company a general rate increase.

(3) The filing shall also include a summary document which briefly states the following information, annualized, as applicable. In presenting the following information, the company shall itemize revenues from any temporary, interim, periodic, or other noncontinuing tariffs. It shall include in its rate change percentage

and revenue change calculations any revenues from proposed general rate change tariffs that would supersede revenue from noncontinuing tariffs.

(a) The date and amount of the latest prior general rate increase authorized by the commission, and the revenue realized from that authorized increase in the test period, based on the company's test period units of revenue.

(b) Total revenues at present rates and at requested rates.

(c) Requested revenue change in percentage, in total and by major customer class.

(d) Requested revenue change in dollars, in total and by major customer class.

(e) Requested rate change in dollars, per average customer by customer class, or other representation, if necessary to depict representative effect. Filings shall also state the effect of the proposed rate increase in dollars per month on typical residential customers by usage categories.

(f) Most current customer count, by major customer class.

(g) Current authorized overall rate of return and authorized rate of return on common equity.

(h) Requested overall rate of return and requested rate of return on common equity, and the method or methods used to calculate rate of return on common equity.

(i) Requested capital structure.

(j) Requested net operating income.

(k) Requested rate base and method of calculation, or equivalent, which it contains.

(l) Requested revenue effect of attrition allowance, if any is requested.

. . .

(5) The most recent annual report to shareholders, if any, and any subsequent quarterly reports to shareholders; the most recent FERC Form 1, if applicable; and for the most recent two years prior to the filing date, supply the company's Form 10Ks, Form 100s, any prospectuses for any issuances of securities, and quarterly reports to stockholders, if any.

(6) Any cost studies relied upon by the company in support of its filing. In addition, the company shall identify all cost studies conducted in the last five years for any of

the company's services, together with a description of the methodology used in such studies.

WAC 480-09-466 Settlement conference; settlements, provides in relevant part:

The commission favors the voluntary settlement of disputes within its jurisdiction. It will approve settlements when doing so is lawful and when the result is appropriate and consistent with the public interest in light of all the information available to the commission. . . .

(2) Settlements. A settlement is an agreement among two or more parties to a proceeding to resolve one or more issues.

(a) The commission may exercise discretion whether to accept a proposed settlement for its review. If the commission accepts a settlement for review in an adjudication, the commission will schedule a time at a hearing session for parties to present the settlement and for the commissioners to inquire about it, unless the commission believes such a session to be unnecessary for it to exercise informed judgment upon the proposal.

(b) Partial settlement. An agreement of all parties on some issues may be presented as a partial settlement for commission review, and remaining matters may be litigated.

(c) Multiparty settlement. An agreement of some, but not all, parties on one or more issues may be offered as their position in the proceeding, with the evidentiary proof that they believe appropriate to support it, for commission review. Nonsettling parties may offer evidence and argument in opposition.

(d) Parties shall advise the commission when they have reached a partial or multiparty settlement and may suggest preferred procedural alternatives for review of the settlement. The commission will determine the appropriate procedure.

WAC 480-146-350 Filing of affiliated interest transactions.

Every public service company must file a verified copy, or a verified summary, if unwritten, of contracts or arrangements with affiliated interests before the effective date of the contract or arrangement. Verified copies of modifications or amendments to the contract or arrangements must be filed before the effective date of the modification or amendment. If the contract or arrangement is unwritten, then a public service company must file a verified summary of any amendment or modification. The commission may institute an investigation and disapprove the contract or arrangement if the commission finds the public service company has failed to prove that it is reasonable and consistent with the public interest.

WAC 480-146-360 Reporting of affiliated interest transactions.

(1) Every public service company, as defined in the application of rules WAC 480-146-240, must file with the commission by June 1 of every year an annual report of all affiliated interest transactions that occurred during the period January 1 through December 31 of the preceding year.

"Affiliated interest transactions" mean contracts or arrangements between affiliated interests as defined in RCW 80.16.010.

(2) The annual report must include a corporate organization chart of the public service company and its affiliates.

(3) The annual report must contain the following information for each affiliate that had transactions with the public service company during the preceding year:

(a) A description of the products or services flowing between the public service company and any affiliated interest;

(b) A description of the pricing basis or costing method and procedures for allocating costs for such products or services rendered, and the amount and accounts charged;

(c) A description of the terms of any loans between the public service company and its affiliate and a listing of the year-end loan amounts and maximum loan amounts outstanding during the year;

(d) A description of the terms and maximum amount of any debt guarantees by the public service company for any affiliate and a listing of the year end debt amounts and maximum debt amounts outstanding during the year;

(e) A detailed description of the activities of the affiliates with which the public service company has transactions;

(f) A list of all common officers and directors of the affiliated interest company and the public service company along with their titles in each organization, and;

(g) Appropriate financial information for each affiliated interest company including, but not limited to, a balance sheet and income statement.

The commission may request any additional information during its review of the public service company's annual report of affiliated interest transactions.

(4) The annual report required by this section will supersede the reporting requirements contained in previous commission orders authorizing affiliated interest transactions pursuant to chapter 80.16 RCW.

(5) The public service company is obligated to file verified copies of affiliated interest contracts and arrangements as stated in WAC 480-146-350.

Part IV of chapter 34.05 pertaining to Adjudicative Proceedings, including but not limited to RCW 34.05.440, RCW 34.05.449 and RCW 35.05.452 apply generally. Additional parts of Chapters 80.01, 80.04, 80.16 and 80.28 RCW including, but not limited to, RCW 80.04.250, RCW 80.04.350, RCW 80.04.360, RCW 80.28.050, RCW 80.28.060, RCW 80.28.080 apply. Chapters 480-09, 480-80, 480-90 and 480-100 WAC apply generally.