APPENDIX 2

Avista Dockets UE-050482 and UE-050483:
Excerpt from Exhibit 81,
Direct Testimony of Ronald R. Peterson
Representing Avista Corporation
(Cover Page and pages 1 and 2, and 15-28)

Certificate

STATE OF WASHINGTON,)
)
COUNTY OF THURSTON.)

I hereby certify that the foregoing and attached document is a full, true and correct copy of

An excerpt of Exhibit 81 in WUTC Docket UE-050482 (cover page and pages 1, 2, and 15-28) entitled:

Direct Testimony of Ronald R. Peterson, Representing Avista Corporation.

now on file in the office of the Washington Utilities and Transportation Commission at Olympia.

IN WITNESS WHEREOF, *I have hereunto set my hand and affixed the seal of the Washington Utilities and Transportation Commission, this* 15th *day of June, 2006.*

Secretary of the Washington Utilities
and Transportation Commission

S.F. No. 3271 QX A-64

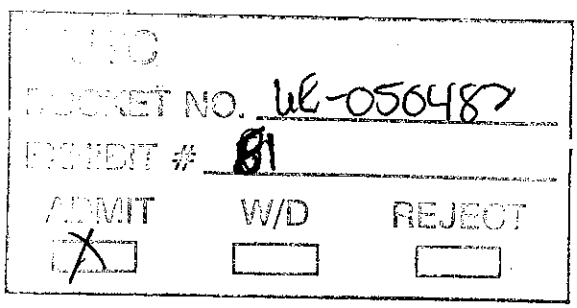
BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-05_____

DIRECT TESTIMONY OF

RONALD R. PETERSON

REPRESENTING AVISTA CORPORATION



I. INTRODUCTION

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

A. My name is Ronald R. Peterson. I am employed as Vice President of Energy Resources by Avista Corporation at 1411 East Mission Avenue, Spokane, Washington.

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

A. I began my career at Avista Corp. in 1975 after graduating from Washington State University with a degree in business administration, majoring in accounting. I passed the Washington State CPA examination in 1976 and worked as a staff accountant in a variety of positions until 1987, when I became Supervisor of the Company's Corporate Accounting function. In 1991, I was selected Customer Service Manager, and in 1992 was elected Treasurer. I was elected Controller and assumed the Director of Information Services responsibilities in 1996. In 1998, I was elected Vice President and Treasurer. I served as both the Corporate Treasurer and Utility Controller beginning in August 2001. I was appointed to my current position in March 2003.

Q. What is the scope of your testimony in this proceeding?

A. My testimony will provide an overview of Avista's resource planning and power operations. I will provide an update on the Company's hydro upgrades, a status report on the Company's FERC license commitments at the Clark Fork River hydroelectric projects, and the current re-licensing effort for the Spokane River hydroelectric projects. Next, I will discuss the Company's acquisition of the second half of Coyote Spring 2 (CS2). I will explain the Company's proposal to eliminate the deadband from the ERM calculations. Finally I will address the Company's proposed treatment of expenses related to two small generating units and

the Company's proposed treatment of production tax credits related to its Kettle Falls wood-fired plant.

A table of contents for my testimony is as follows:

I am sponsoring Exhibit Nos.__(RRP-2) through __(RRP-14), which were prepared under my direction:

Exhibit No.	Description
RRP-2	Resource Planning and Operations
RRP-3	Photo – Cabinet Gorge Hydroelectric Project
RRP-4	Map – Spokane River Hydroelectric Projects
RRP-5	Location of Coyote Springs Plant Relative To Avista Utilities Service Area
RRP-6	Excerpts from 2000 Updated Integrated Resource Plan
RRP-7	Coyote Springs 2 – Letter of Intent
RRP-8	Coyote Springs 2 – Purchase and Sale Agreement
RRP-9	2003 Integrated Resource Plan Excerpts re: Preferred Resource Mix
RRP-1-	August/September 2004 Loads and Resources Position
RRP-11	May 2004 CS2 Analysis
RRP-12	September 2004 CS2 Analysis
RRP-13	Navigant Consulting CS2 Analysis and Valuation
RRP-14	Kettle Falls Production Tax Credit Calculation

Q. Are customers currently benefiting from the second half of CS2?

A. Yes. On January 20, 2005, Avista took ownership of the second half of CS2, and is now owner of 100% of the project. Because of expected poor hydro conditions in 2005, the ERM deadband will be exceeded and 90% of the margins realized from operation of the second half of CS2 will be credited to customers through the ERM process currently in place in Washington. However, until the second half of CS2 is included in rate base, Avista incurs the costs associated with investment in the plant and its operation expenses; neither of which are recovered through the ERM mechanism. Therefore, a mismatch exists between those receiving the benefits vs. those incurring certain expenses associated with the second half of CS2 until the Commission approves the inclusion of the remaining share of CS2 in base rates.

V. ASSESSMENT OF RESOURCE NEED RELATED TO MIRANT'S SHARE OF CS2

Q. Is the acquisition of the second half of CS2 consistent with Avista's Integrated Resource Plan?

A. Yes. Avista's most recent IRP (April 2003) identified a Preferred Resource Strategy (Resource Strategy) including a mix of wind, coal, conservation, and natural gas-fired resources. The report focused on supply diversity and the need to reduce both future costs and price volatility. In total, the need for new resource additions through 2013 totaled more than 400 aMW. As explained earlier, in addition to the acquisition of the second half of CS2, Avista has added a variety of resources to its portfolio in recent years including 35 MW of wind capability, small generation contracts, market purchases, DSM, and hydroelectric upgrades.

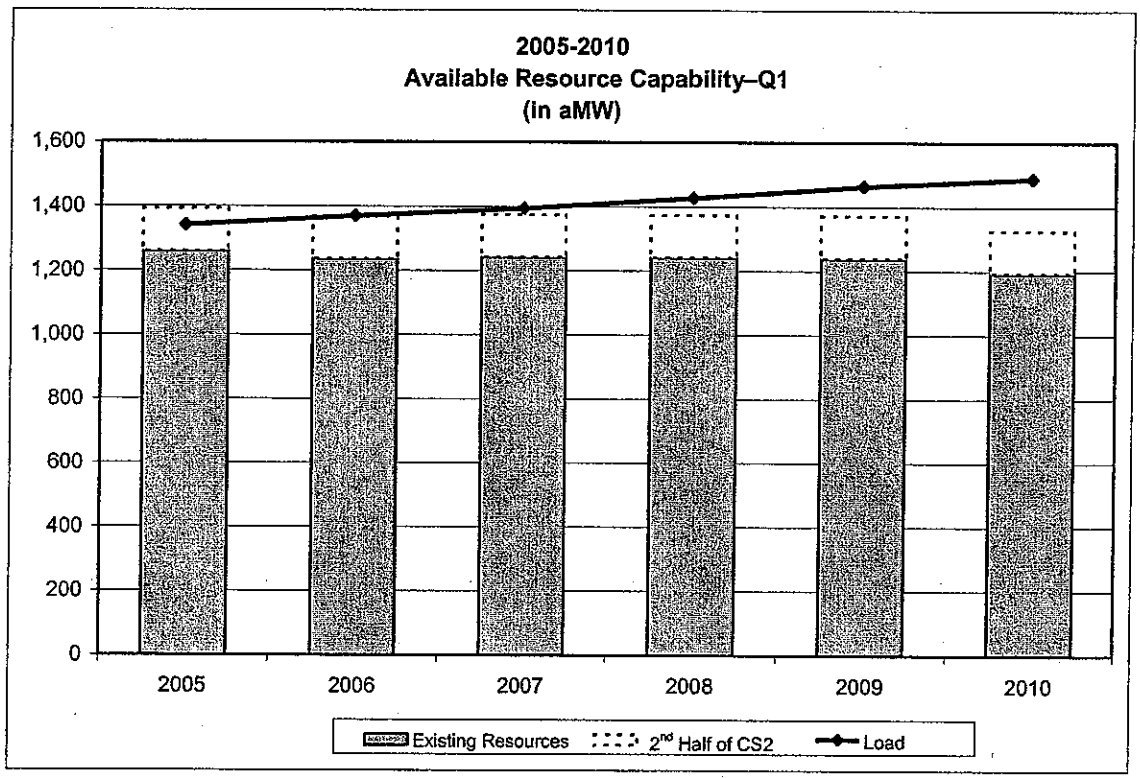
The natural gas-fired combined-cycle component of the 2003 IRP Resource Strategy equaled 149 aMW. The opportunity to acquire the remaining half of CS2, at 140 MW, is consistent with the 2003 IRP long-term Resource Strategy. Excerpted pages from the 2003 IRP, which show the natural gas-fired combined cycle component of the Resource Strategy, are attached in Exhibit No.__(RRP-9). A complete copy of the 2003 IRP has been provided in the workpapers of this filing.

Q. Did Avista's load and resource position show a resource need at the time of the acquisition of the second half of CS2?

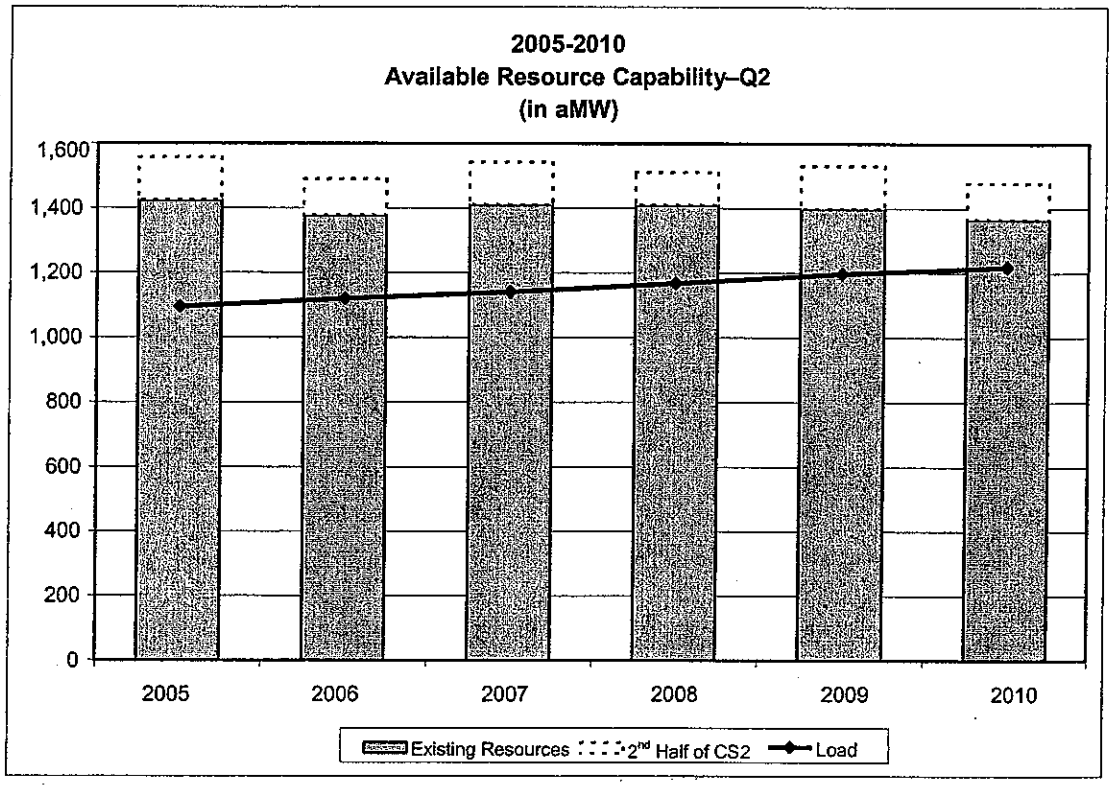
A. Yes. The Company's loads and resources (L&R) positions are updated periodically to reflect various resource additions, deletions, and modifications, as well as changes in Avista's load obligations. The Company's L&R at the time the Company entered into the agreement to acquire Mirant's share of CS2, showed energy resource deficiencies in the 1st, 3rd and 4th quarters of 2005 and future years, absent the second half of CS2. Excerpts from the Company's August/September 2004 loads and resources position are included in Exhibit No.__(RRP-10). (The entire reports have been included in workpapers.) Although the addition of the second half of CS2 adds to Avista's surplus energy during the 2nd quarter, under many operating conditions a natural gas-fired combined cycle project such as CS2 would be displaced by lower priced power during the spring runoff period in the 2nd quarter, and would not be running. The second half of CS2, however, is a needed addition to Avista's resource base by covering deficits in Q1, Q3, and Q4.

The following chart shows the Company's August/September L&R positions for the 1st quarter of each year from 2005 through 2010. The chart shows that Avista's existing resources

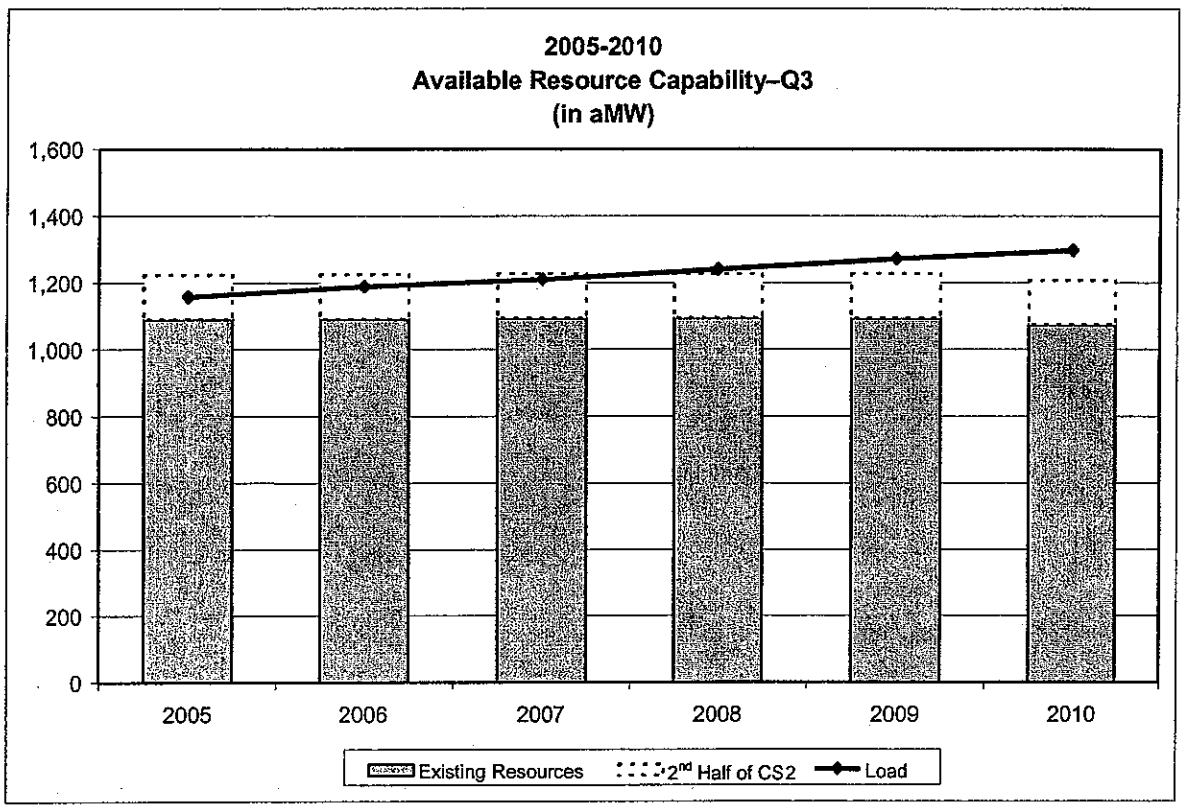
for the 1st quarter of each year, for planning purposes, are not sufficient to cover the Company's load. As the loads continue to grow over time, they exceed available resources including the second half of CS2.



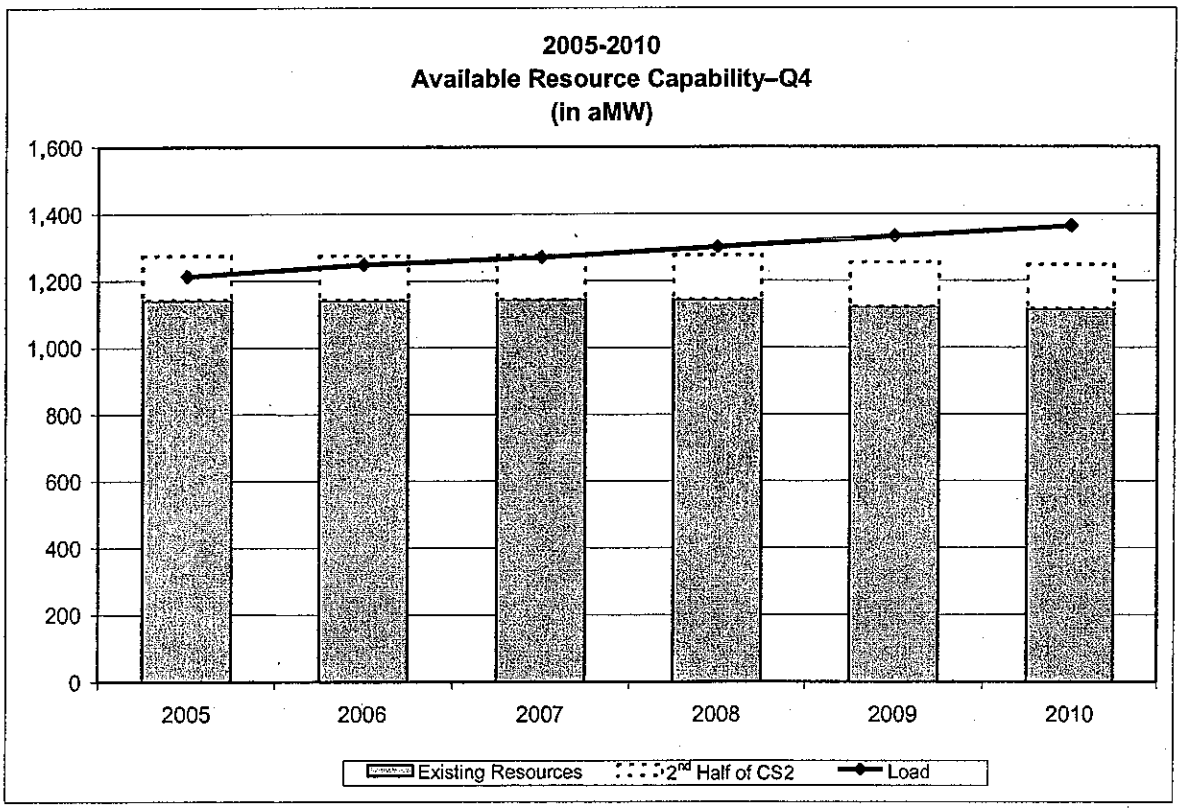
The next chart shows the Company's L&R positions for the 2nd quarter of each year from 2005 through 2010. The chart shows a surplus on Avista's system for the 2nd quarter, both with and without the second half of CS2. This is caused by the increased availability of hydroelectric generation in the 2nd quarter, as well as the fact that loads are generally lower given the relatively mild temperatures in the same period.



The following two charts show the Company's L&R positions for the 3rd and 4th quarters of each year from 2005 through 2010. The charts show that Avista's existing resources for the 3rd and 4th quarters of each year, for planning purposes, are not sufficient to cover the Company's load. Again, as the loads continue to grow over time, they exceed available resources including the second half of CS2.

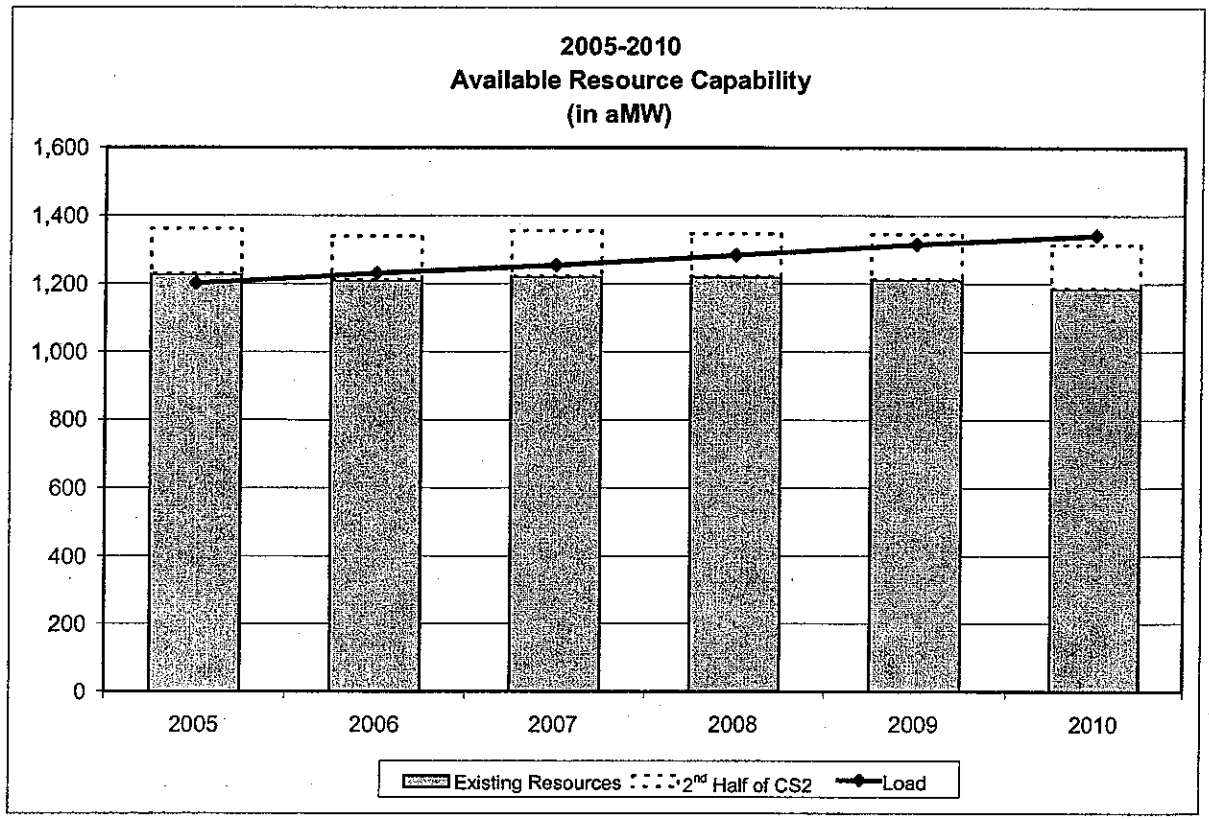

2005-2010
Available Resource Capability–Q3
(in aMW)
1,600
1,400
1,200
1,000
800
600
400
200
0
2005
2006
2007
2008
2009
2010
Existing Resources
2nd Half of CS2
Load

1


2005-2010
Available Resource Capability–Q4
(in aMW)
1,600
1,400
1,200
1,000
800
600
400
200
0
2005
2006
2007
2008
2009
2010
Existing Resources
2nd Half of CS2
Load

2

The final chart below shows the Company's L&R positions for each calendar year 2005 through 2010. In developing this chart, the surpluses in the 2nd quarter of each year are averaged with the deficiencies in the 1st, 3rd and 4th quarters. The 2nd quarter surpluses "mask" the deficiencies in the other three quarters.



These charts illustrate how the addition of the second half of CS2 will fit very well in Avista's resource base by covering deficiencies in the 1st, 3rd and 4th quarters of each year. The addition of the second half of CS2 therefore meets important resource needs in three quarters of each year beginning in 2005.

VI. ECONOMIC ANALYSES AND PURCHASE PRICE FOR MIRANT'S SHARE OF CS2

Q. What economic analyses did the Company conduct prior to the purchase of the second half of CS2?

A. With regard to the economic analyses underlying the purchase price of $62.5 million, the Company performed two separate evaluations of Mirant's half of CS2: one in May 2004 and a second in September 2004. The first evaluation, completed on May 7, 2004, was comprised of eight scenarios. The eight scenarios came from four different forward analyses of the marketplace, combined with two transmission scenarios.[5] The transmission scenarios examined, first, the effect of the procurement of firm transmission on a year-around basis and, second, circumstances where the plant would be constrained during the second quarter due to transmission curtailments on the BPA system.[6]

Using the Aurora dispatch model, the Company performed the various scenarios to reflect the potential future value of CS2. The May 2004 Base Case scenario included a combination of forward market prices through 2008, followed by 2003 IRP prices through the end of the 20-year study period, and the assumption that the plant would not be available to serve load or sell into the wholesale marketplace in the second quarter due to transmission constraints as described above.

The Base Case value from the May analysis, which was used by Avista in its negotiations with Mirant, was $68.0 million. The remaining scenarios ranged from $43.1 to $116.9 million. The May Base Case analysis showed an expected net present value ratepayer savings of $7.5

[5] Mirant did not procure firm transmission for its share of CS2. Avista plans to "firm up" transmission for the plant, as explained later in this Testimony.

million over the study period based on the purchase price of $62.5 million. The May 2004 analysis is provided in Exhibit No.__(RRP-11).

Avista continued to perform analyses after signing the non-binding Letter of Intent (LOI) in July 2004. Transmission alternatives were also reviewed. Avista completed its second economic evaluation in September 2004. Six of the original scenarios were revisited, resulting in a Base Case valuation equal to $66.7 million, as compared to the original study estimate of $68.0 million. The September 2004 analysis is provided in Exhibit No.__(RRP-12).

Q. Are there other benefits related to the acquisition?

A. Yes. In addition to the economic value and ability to meet retail load requirements, full ownership of CS2 brings other benefits to the Company and its customers. Full ownership by Avista would improve the Company's ability to economically operate CS2. When Mirant was a partner in the CS2 project, it periodically chose to not run the plant when Avista wanted to. Although the joint operating agreement for CS2 allowed the entity interested in running the plant to take the entire output of CS2, this arrangement did not allow Avista to plan on a forward basis to meet load with the plant. If Avista was already in a balanced load and resource position at the pre-schedule time when Mirant made its decision to not operate, the Company would need to go to the pre-schedule market on a very short timeframe (1-2 hours) to purchase natural gas fuel and to sell surplus power in order to operate CS2. Full ownership will avoid this last-minute decision-making, and enhance the value of CS2 by allowing dispatch decisions to be made days and months ahead of actual operations.

[6] Firm transmission is currently not available at the CS2 locations on a long-term annual basis primarily due to peak hydroelectric generation during the second quarter.

Further, decisions can be made faster in the event of unexpected plant de-rating or outages, or in the event capital upgrades or replacements are necessary. While each of these items is not in and of itself greatly significant, together they add up to a meaningful improvement in the ownership and operation of the CS2 project.

Q. How does the cost of the second half of CS2 compare with other combined cycle combustion turbine plants?

A. As part of its review of the CS2 second half acquisition, Avista looked at the costs of other comparable natural gas-fired combined cycle projects. While few combined cycle plants have changed hands in the West, documentation on new plant costs are readily available. The information in the table below consists of data regarding estimates of new combined cycle construction costs and available information on the recent acquisition of the Fredrickson project by Puget Sound Energy. The CS2 purchase price of $62.5 million, or $439 per kW of installed capacity, is significantly below the cost of comparable projects, including prices for larger projects with a different configuration that tend to have a lower cost per-kW due to economies of scale.[7]

[7] Some larger gas-fired projects are configured with two combustion turbines "attached" to one heat recovery steam generator (2x1 combined cycle project). 1x1 plants have one combustion turbine attached to a heat recovery steam generator. The 2x1 configuration generally results in a lower cost per installed capacity due to economies of scale.

Comparison Data for Combined Cycle Plant Costs in the Northwest

Source	Installed Cost ($/kW)	Notes
2nd Half CS2 Price	**$439**	**1x1 configuration**
AVA 2003 IRP	$757	1x1 configuration
NWPCC Estimate	$606	2x1 configuration
PSE Frederickson - Low	$558	WSJ article
PSE Frederickson - High	$590	PSE press release
PGE Port Westward - Low	$590	2x1 configuration
PGE Port Westward - High	$670	1x1 configuration
Idaho Power Draft '04 IRP	$617	2x1 configuration
IPUC – Avoided Cost[8]	$736	Order 26017, 1x1
PacifiCorp 2003 IRP	$670	Unit type unknown
PSE 2003 IRP	$661	2x1 configuration

Q. Did the Company obtain an independent review of the second half of CS2 acquisition?

A. Yes. The Company hired an external consultant to provide an independent assessment that could be used by management in its decision-making. This assessment was designed to take a fresh look at the valuation analysis, through independent eyes. Accordingly, Avista hired Navigant Consulting, Incorporated (NCI) to complete three tasks prior to the Company proceeding with the transaction: 1) review Avista's overall methodology and analyses; 2) develop an independent valuation of Mirant's share of CS2, to include base, low, and high scenarios; and 3) compare the CS2 price to comparable power plant transactions occurring in the Northwest and Western United States Region. The Navigant report is attached to this filing as Exhibit No.__(RRP-13).

[8] Surrogate combined cycle combustion turbine project cost.

Navigant developed an independent assessment of the future value of Mirant's share of CS2. The consultant modeled low, base, and high valuation cases using a Prosym™ model. Navigant found a base case value of $67.2 million for Mirant's interest in CS2, which is very close to the Avista September 2004 results of $66.7 million.

The Navigant evaluation indicated that the acquisition of Mirant's share of CS2 for utility customers was reasonable. In its conclusions, Navigant stated:

> Avista's base case valuation ... for the remaining 50% of Coyote Springs II reflects a reasonable valuation for this facility and compares favorably to the other transactions consummated in the Pacific Northwest which have averaged $561/kW. (Page 15 of the Navigant report) (emphasis added)

Navigant went further to explain:

> NCI's independent analyses and base case valuation results reflect a value of $67.2 million ($472/kW) for 50% of the Coyote Springs II facility... Therefore, based upon our review of the Avista analyses, our own independent analyses, and comparable generation transactions consummated in the market, NCI believes that Avista's negotiated purchase price of $62.5 million for 50% of the Coyote Springs II facility is reasonable. The negotiated purchase price is below the Avista and NCI base case valuation results of $66.7 million and $67.2 million respectively. (Page 15 of the Navigant report) (emphasis added).

Q. How has Avista addressed the transmission needs of the second half of Coyote Springs 2?

A. Avista included in its analyses the cost of BPA long-term firm transmission to move power from the second half of the CS2 project to its system. BPA currently indicates that no additional annual long-term firm transmission capability is available to move more power from CS2 to the Company's system, due to transmission constraints during the spring hydroelectric runoff period. Transmission is generally available, however, during the 1st, 3rd and 4th quarters of the year when Avista needs the generation.

Through acquisition of the second half of CS2, Avista has the opportunity to acquire Mirant's higher position in the BPA queue for long-term firm transmission requests. Avista also made its own long-term firm transmission request to BPA for the CS2 transaction. Avista may acquire firm long-term BPA transmission through either of those processes. Avista is also participating in the 2005 BPA open season for transmission upgrades to the John Day – McNary 500 kV transmission line that will, if agreements are reached, provide adequate long-term firm transmission from the CS2 project to its system. The BPA open season would replace the transmission queue requests.

In the near-term Avista plans to contract with third parties for short-term BPA transmission, for buy-sell arrangements, and/or for energy exchange arrangements. These opportunities will allow the same energy transfer that would occur with a firm BPA transmission purchase. Preliminary discussions with BPA indicate that adequate short-term transmission capacity will be available for Q1, Q3, and Q4. In the Company's experience, non-firm transmission has very seldom been curtailed by BPA. Avista's Base Case valuation of the CS2 transaction factors in costs relating to transmission and recognizes that BPA may have a constraint that restricts the Company's ability to transfer additional CS2 power during the second quarter of each year. This conservative view of Q2 transmission availability over the life of the project has only a modest impact on the value of CS2. The plant produces a small portion of its economic value during the second quarter.

Q. What arrangements have been made to transport natural gas to the plant?.

A. Natural gas transportation for CS2 includes three components: AECO to Kingsgate; Kingsgate to the Coyote Springs Lateral; and the Coyote Springs Lateral. At full

output, the 280 MW CS2 project (100% share) consumes approximately 43,000 decatherms (dth) per day.

For the AECO to Kingsgate portion, Avista holds 34,138 dth per day from the TransCanada Pipeline's 2003 expansion project, through October 2028. Avista Utilities also had available an additional 10,268 dth of capacity for its retail natural gas distribution business that has been reassigned through October 2008. This results in total delivery to CS2 equal to 44,406 dth per day.

Avista holds 16,500 dth per day through October 2028 on the Kingsgate to Coyote Springs lateral. This capacity was obtained as part of Gas Transportation Northwest's (GTN) 2003 expansion. Avista also holds 10,000 dth per day on GTN that has been reassigned from its retail natural gas distribution business, resulting in total delivery capability of 26,500 dth per day. Effective on January 20, 2005, the Company acquired an additional 16,500 dth per day, through October 2028, bringing the total capacity on this GTN leg to 43,000 dth per day.

Avista and Mirant each held contracts for 28,626 dth per day through October 2015 on the Coyote Springs Lateral. Mirant agreed as part of the CS2 transaction to transfer its existing rights on the lateral to Avista as part of the sale, giving Avista a total of 57,252 dth per day delivery capability on the lateral.

Q. Can you summarize why the acquisition of the second half of Coyote Springs 2 was prudent for Avista?

A. Avista had immediate needs for resources in each of quarters 1, 3,and 4 beginning in 2005 and increasing into the future. As an efficient combined cycle combustion turbine resource which produces most of its margin benefit in 1st, 3rd and 4th quarters, the acquisition of the

second half of CS2 is a good fit for meeting Avista's resource need now and into the future. The second half of CS2 is also a cost-effective resource acquisition as illustrated by Avista's economic analysis, the independent economic analysis of Navigant Consulting Inc., and by comparison against comparable generation transactions consummated in the market.

VII. PROPOSAL TO ELIMINATE ERM DEADBAND

Q. Would you please begin by describing the basic features of the ERM as it exists today, and the change that the Company is proposing to make?

A. Yes. The ERM (Energy Recovery Mechanism) was implemented in Washington in July 2002, and was designed to provide a means for recovering power supply costs that were prudently incurred, but beyond the reasonable control of the Company. On a monthly basis the Company's actual power supply costs are compared with the power supply costs included in base retail rates to determine the monthly change in costs. Under the ERM, Avista absorbs or retains the first $9.0 million of cost differences during a calendar year, and 90% of the excess over the $9.0 million is deferred for future rebate or surcharge to customers.

The costs included in the ERM are purchased power expenses and thermal fuel costs. Wholesale sales revenues are also included as a credit against the purchased power and fuel costs. Although there are a number of factors that cause the actual power supply costs to be different that those included in base retail rates, the primary drivers, by far, are hydroelectric generation conditions, natural gas prices for thermal generation, and wholesale electric market prices. All of these factors are substantially beyond the control of the Company and are impossible to predict with any meaningful degree of accuracy.