Exhibit No. __(KON-1T)

REVISED Pages 10 and 21-26 – May 25, 2012

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12_______

DOCKET NO. UG-12_______

DIRECT TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

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

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

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

By comparison, the revised Attrition Adjustment developed by Dr. Lowry is $~~20.5~~21.6 million. Therefore, the attrition adjustment proposed by Avista would appropriately address the revenue shortfall that the Company is experiencing.

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

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lack of competition is offset with regulation. As Dr. Bill Avera states in his testimony, the U.S. Supreme Court, in the <u>Bluefield</u> and <u>Hope</u> cases, found that a utility's allowed ROE should be sufficient to: 1) fairly compensate the utility's investors, 2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and 3) maintain the utility's financial integrity. Dr. Avera explains in his testimony, "To be fair to investors and to benefit customers, a regulated utility must have an <u>opportunity to actually earn</u> a return that will maintain financial integrity, facilitate capital attraction, and compensate for risk. In other words, it is the end result in the future that determines whether or not the *Hope* and *Bluefield* standards are met.

[4] 2011 restated rate base of $1,327,815,000 x 48.4% equity layer x 2.00% equity return, divided by conversion factor of .620815 = $20.7 million.

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

Q. Would you be more specific?

A. Yes. As noted, Dr. Lowry used prior Commission Basis Reports to develop trends in revenues, expenses, and rate base. He then applied the trends to amounts contained in the 2011 Commission Basis Report to develop trended values out to the rate effective period of calendar year 2013. In the case of power supply-related revenues and expenses, Dr. Lowry used the amounts developed by the Company, as discussed and presented by Company witness Mr. Johnson. In the case of retail revenue, Dr. Lowry used the Company's forecast of loads for 2013 with revenue associated with load growth being determined using a weighted billing determinant index. Since the rate increase in this proceeding will be applied to the 2011 test period billing determinants, Dr. Lowry divided his rate year, attrition-adjusted revenue requirement by the revenue growth factor to reduce the revenue requirement to be applied to the test period level of retail loads. The result of Dr. Lowry's analysis is ~~an~~a revised overall revenue requirement of $~~41.502~~42.569 million, including the impact of attrition.

The attrition-adjusted subtotal[8] of the revenue requirement of $41.502 million was originally developed using Dr. Lowry's attrition adjustment of $20.5 million, as included in his direct testimony (Exhibit No. ___MNL-1T) and Exhibit No. ____(MNL-5) filed on April

[8] This attrition-adjusted subtotal of $41.502 million appears at p. 9, col. AA-Ttl, l. 50 of Exhibit No. ___(EMA-2). After then giving effect to further adjustments for the retail revenue credit, the depreciation study, and other O&M offsets, the final revenue requirement is $40.983 million, and is what the proposed tariffs seek to recover. (See Exh No. ____(EMA-2), p. 10, col. F-Ttl, l. 50)

2, 2012. Since then, however, he has made necessary revisions to reflect the effect of converting from logarithmic growth factors to arithmetic growth factors for the two year escalation rates that are used to rend the 2011 base year amounts to the 2013 rate year amounts in his attrition study. The conversion was inadvertently overlooked when preparing the original exhibit. The result of the change is to increase the attrition-adjusted revenue requirement from $41.502 million to $42.569 million. This revision is shown in Dr. Lowry's supplemental exhibit (Exhibit No ___(MNL-5)(Supp.), at page 2, column J, line 56.

The Company, however, is not proposing to increase its filed-for revenue requirement (or modify its proposed tariffs) to reflect Dr. Lowry's revised calculations as shown in his Exhibit No. ___ (MNL-5)(Supp.). The effect of his revisions would have increased the attrition adjustment from $20.5 million to $21.6 million, thereby increasing the attrition-adjusted subtotal for the revenue requirement from $41.502 million to $42.569 million. Company witness Andrew's derivation of the requested revenue requirement, however, still makes use of Dr. Lowry's original attrition adjustment of $20.5 million in arriving at her "Attrition Adjusted Total" in Exhibit No. ___ EMA-2, p.9, Col. AA-Ttl, line 50.[9]

Q. What did Dr. Lowry conclude?

A. His analysis demonstrates that Avista's costs will grow much more rapidly than its billing determinants between 2011 and 2013, resulting in continued underearning, absent an Attrition Adjustment. As such, he proposes an Attrition Adjustment of

[9] Because Witness Andrews continues to make use of Witness Lowry's original attrition adjustment of $20.5 million (not $21.6 million) for purposes of developing the overall revenue requirement upon which the proposed tariffs are based, the Company is still offering into evidence the original Exh No. ___MNL-5 (containing the basis for the $20.5 million attrition adjustment), even though Dr. Lowry's supplemental exhibit (MNL-5 (Supp)) would show a slightly higher attrition adjustment of $21.6 million, after making certain corrections.

approximately $~~20.5~~21.6 million~~, which is reflected in the proposed revenue requirement of the Company~~.[10] Stated differently, he estimates a revenue deficit of about $~~20.5~~21.6 million in 2013, the first year new rates are in effect, if the revenue increases were to be limited only to the pro forma adjustments proposed by the Company~~. (Id. at p. 3, ll 3-10). The revenue adjustment associated with his Attrition Adjustment is shown in Company witness Ms. Andrew's Exh. No. ____(EMA-2) at page 9, columns AA-Ttl, line 49.~~

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

A. No, it wouldn't. The difference in electric revenue requirement between an AMA verses year-end rate base for 2011 is $5.363 million (which includes the effect of depreciation). (See Exh. No. ____(EMA-2), p.8, col. (3.07), line 50). The Attrition Adjustment developed by Dr. Lowry for the period of 2012-2013, represents an additional $~~20.5~~21.6 million of necessary rate relief. Therefore, simply adopting year-end rate base, without more, will not solve the Company's earnings attrition.

Q. As a "cross-check" on the reasonableness of Dr. Lowry's Attrition Adjustment showing a $~~20.5~~21.6 million shortfall in 2013, did Ms. Andrews also analyze the effect of growth in rate base and the impact of DSM through 2013?

A. Yes, she did. Ms. Andrews started with the unadjusted results of operations for 2011 and prepared specific restating and pro forma adjustments that have, at various

[10] ~~He~~ In his revised testimony he derives an overall revenue requirement (including attrition) during the 2013 rate year of ~~$41.502~~$42.569 million (Exh. ___(MNL-5)(Supp.), p. 2, l. 56), from which the Company subtracted $20.988 (representing pro forma adjustments sponsored by Ms. Andrews in Exh. ___EMA-2, p. 9, l. 50), in order to isolate the attrition portion of his adjustment (~~$20.5~~$21.6 million) as mentioned above, however, the Company's filed-for revenue requirement is based on Dr. Lowry's original estimate of attrition in 2013 of $20.5 million.

times, been adopted in prior rate cases. As such, she pro formed plant investment through the end of the 2011 historical test period (year-end test period rate base). She presented an analysis of what the revenue requirement would have been if the costs associated with rate base for the 2013 calendar year were included. They include incremental additions to rate base to reflect: 1) 2012 Year-End Rate Base, and 2) 2013 AMA Rate Base. Company witness Mr. DeFelice provides additional testimony related to these components.

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

The total revenue requirement associated with the three components of Ms. Andrews' analysis, including the 2012 planned capital expenditures, the 2013 planned capital expenditures and the impact of DSM, is $20.4 million. By comparison, Dr. Lowry's Attrition Adjustment~~, used by the Company for purposes of deriving a revenue requirement,~~ is $~~20.5~~21.6 million. As I discuss elsewhere in my testimony, the Company has been experiencing a revenue shortfall of at least 200 basis points in ROE, which is equal to approximately $21 million.

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

A. Yes. Dr. Lowry used a historical trend analysis to develop a total, attrition-adjusted revenue requirement used by the Company. His revenue requirement includes the shortfall that existed during the 2011 test period as well as the shortfall that exists between the 2011 test period and the 2013 rate year. Ms. Andrews, on the other hand, used specific pro forma adjustments coupled with an analysis of planned capital expenditures and DSM impact through the 2013 rate year. The results of her analysis are consistent with those of Dr. Lowry, even though both approached the issue in an entirely different way: Dr. Lowry developed an Attrition Adjustment based on trending of historical data (as in prior attrition studies accepted by this Commission), while Ms. Andrews essentially arrived at a revenue shortfall based on actual, planned investments and DSM impacts through 2013. The end result of the two separate, independent methodologies provides a confirmation that the attrition-adjusted revenue requirement under either method is reasonable and supportable.

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

A. ~~The~~As previously noted, the total revenue requirement (reflecting attrition) originally developed by Dr. Lowry's Attrition Study is used by Ms. Andrews' for the final adjusted results and revenue requirement. Although Dr. Lowry's revised attrition analysis would produce a higher attrition adjustment, the Company is not proposing a higher revenue increase in this case based on Dr. Lowry's revised attrition study. The adjustments and values shown in Ms. Andrews' exhibit (Exh. No. ___(EMA-2), p.9) however, were used for the limited purpose of preparing the cost-of-service study that is presented by Company witness Ms. Knox, because these values more readily lend themselves to Ms. Knox's cost-of-service analysis. This is because expenditures related to specific plant are only set forth in the necessary detail in Ms. Andrews' analysis as required for purposes of assigning and allocating such expenses to their appropriate functional classifications for cost-of-service purposes.

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

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

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

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

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

A. Yes.