EXHIBIT NO. _____ (RCC-IT)
DOCKET NO. UE-110876/UG-110877
2011 AVISTA GENERAL RATE CASE
WITNESS: RALPH C. CAVANAGH

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	)	DOCKET NOS. UE-110876 and UG-110877 (*Consolidated)*

DIRECT TESTIMONY (NON-CONFIDENTIAL) OF
RALPH C. CAVANAGH
ON BEHALF OF NW ENERGY COALITION

November 3, 2011

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I. IDENTITY AND QUALIFICATIONS OF THE WITNESS

Q. Please state your name and address.

A. I am Ralph Cavanagh, and my address is c/o Natural Resources Defense Council, 111 Sutter Street, 20th Floor, San Francisco, California 94305.

Q. In what capacity are you submitting this testimony?

A. I am a witness for the NW Energy Coalition ("the Coalition").

Q. What are your qualifications?

I am a graduate of Yale College and Yale Law School, and I joined the Natural Resources Defense Council ("NRDC") in 1979. I am a long-time member of the faculty of the University of Idaho's *Utility Executive Course*, and I have taught courses on utility regulation as a Visiting Professor at Stanford and the University of California, and as a Lecturer on Law at Harvard. From 1993-2003, I served as a member of the U.S. Secretary of Energy's Advisory Board, and I am now a member of the Secretary's Electricity Advisory Board. My current board memberships include the Bonneville Environmental Foundation, the Center for Energy Efficiency and Renewable Technologies, the Bipartisan Policy Center, the Renewable Northwest Project, and the Coalition. I have received the Heinz Award for Public Policy (1996) and the Bonneville Power Administration's Award for Exceptional Public Service (1986). My first testimony to the Washington Utilities and Transportation Commission ("WUTC") was submitted in 1986 on the issue of Puget Power's energy efficiency investments, and my first article on revenue decoupling for utilities was published in 1988.[1] I have testified on several subsequent occasions in Puget and PacifiCorp cases, but this is my first appearance as a witness in an Avista

[1] R. Cavanagh, Responsible Power Marketing in an Increasingly Competitive Era, 5 Yale Journal on Regulation (July 1988); more recently, see R. Cavanagh, Reinventing Competitive Procurement of Electricity Resources, Electricity Policy.com (October 2010).

rate proceeding.

II. SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A. ALJ Friedlander's June 28, 2011 Notice of Bench Request in this proceeding reiterated the Commission's "policy preference for full decoupling" from its November 2010 Policy Statement,[2] and invited intervenors to provide the Commission with full decoupling proposals. This testimony responds to that invitation, proposing full decoupling for Avista's retail electricity sales (I do not address the existing natural gas lost margin recovery mechanism). My testimony also supports and is consistent with the Settlement Stipulation submitted to the Commission by other parties to this proceeding, except that I do not agree that consideration of a decoupling mechanism should be deferred. The case for approving this full electric decoupling proposal is underscored by a straightforward summary of the record in this proceeding: if Avista helped its customers save just one percent of systemwide electricity use per year every year for the next five years, it would automatically lose almost $38 million in authorized fixed-cost recovery. These losses would occur regardless of the cost-effectiveness of those savings. The Settlement Stipulation, whatever its other merits (which I do not challenge), does nothing to address this problem.

III. A BRIEF HISTORY OF REVENUE DECOUPLING IN WASHINGTON STATE

Q. Could you briefly review the history of electric decoupling in Washington, which dates to the early 1990s?

A. The Commission approved a decoupling mechanism based on a per-customer revenue cap mechanism for Puget Power in 1991. As the Commission determined at that time:

[2] Docket No. U-100522.

> "[T]he revenue per customer mechanism does not insulate the company from fluctuations in economic conditions, because a robust economy would create additional customers and hence, additional revenue. Furthermore, the Commission believes that a mechanism that attempts to identify and correct only for sales reductions associated with company-sponsored conservation programs may be unduly difficult to implement and monitor. The company would have an incentive to artificially inflate estimates of sales reductions while actually achieving little conservation.[3]"

The Commission implemented Puget's revenue-per-customer cap by "set[ting] up a deferred account allowing a reconciliation of revenue and expenses that would be subject to hearing and review."[4] In its initial review of the mechanism that it had adopted two years earlier, the Commission in 1993 "accept[ed] the parties representations" that the revenue-per-customer cap had "achieved its primary goal—the removal of disincentives to conservation investment," and concluded that "Puget has developed a distinguished reputation because of its conservation programs and is now considered a national leader in this area."[5] Based on these findings, the Commission granted a three-year extension of the revenue-per-customer cap.[6] In 1995, as part of a litigation settlement proposal intended to create no precedent, Puget and several other parties filed a request with the Commission to terminate a complex system of rate adjustment mechanisms that included the revenue-per-customer cap (along with, e.g., a controversial approach to allocating risks of hydropower fluctuations). The Commission approved that request, but the proposal itself expressly reserved the right of all parties to bring forward in the

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[3] Docket No. UE-901183-T, Third Supplemental Order (April 10, 1991), p. 10. The Commission also determined that the mechanism did not constitute retroactive ratemaking, and that it was "fair, just and reasonable" even though it did not perfectly match costs and rates: "even under the current system of ratemaking, costs and rates will diverge immediately following implementation of a rate change." Id. at p. 10.

[4] Id., at p. 10.

[5] See Washington UTC, Eleventh Supplemental Order, Docket No. UE-920433, p. 10 (Sept. 21, 1993).

[6] See id. , p. 10 (concluding that "the PRAM/decoupling experiment should continue for at least another three-year cycle").

future "other rate adjustment mechanisms, including decoupling mechanisms, lost revenue calculations, [and] similar methods for removing or reducing utility disincentives to acquire conservation resources."[7]

Q. Could you summarize the more recent history of electric decoupling proposals in Washington?

A. In 2004, the Commission invited PacifiCorp and other stakeholders to begin discussions regarding the design of a decoupling mechanism in its order approving a settlement proposal by NRDC, the Commission staff, and PacifiCorp.[8] In 2006, the Commission rejected a specific proposal by PacifiCorp and NRDC, in part because continuing disputes over multi-state allocation of the company's fixed-cost revenue requirement made it impossible to calculate Washington's share of that revenue requirement, a prerequisite for any decoupling mechanism.[9]

The most important recent development, however, is the Commission's Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets ("Policy Statement"), issued on November 4, 2010.[10] My proposal is informed by the history of revenue decoupling in Washington State (and other states), but it is shaped most prominently by the Policy Statement, and in particular by the elements that it calls for as part of the Commission's commitment "[i]n the context of a general rate case," to "consider a full decoupling mechanism for electric and natural gas utilities, which

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[7] Docket No. UE-921262, Joint Report and Proposal Regarding Termination of the Periodic Rate Adjustment Mechanism (Apr. 20, 1995).

[8] See Washington UTC v. PacifiCorp, Docket No. UE-032065, Order No. 06, pp. 29-30 (Oct. 2004) (inviting PacifiCorp, following discussion with other parties, to "propose a true-up mechanism, or some other approach to reducing or eliminating any financial disincentives to DSM investment").

[9] Docket No. UE-05084, Orders 03 & 04 (Apr. 17, 2004), p. 41.

[10] Docket No. U-100522.

will allow a utility to either recover revenue declines related to reduced sales volumes or, in the case of sales volume increases, refund such revenues to its customers." (p. 17).

Q. What makes you think that the Commission might be prepared to endorse full decoupling for Avista's electric operations, despite the extended hiatus between the initial Puget decoupling order back in 1991 and this proceeding?

A. The Commission's Policy Statement concludes that "while a close call, we believe that a properly constructed full decoupling mechanism that is intended, between general rate cases, to balance out both lost and found margin from any source can be a tool that benefits both the company and its ratepayers." (p. 16).

IV. APPLYING FULL DECOUPLING TO AVISTA'S ELECTRICITY REVENUES

Q. What do you mean by "full decoupling," and why do you view it as a generally desirable part of utilities' business model?

A. Under traditional regulation, utilities are discouraged from investing in the best performing and lowest-cost resource—energy efficiency—because it hurts them financially. Fortunately, there is a simple, effective, and proven way to remove this conflict: break the link between the utility's revenue and the amount of energy it sells by adjusting rates to ensure that the utility collects no more and no less than its authorized fixed costs. Combined with other policies to encourage energy efficiency, such "full decoupling" mechanisms can free utilities to help customers save energy whenever it is cheaper than producing and delivering it.

Q. Why does Avista need a full electric decoupling mechanism?

A. My response relies substantially on Avista's responses to the Coalition's discovery requests, which are attached as Exhibits 2-4 (RCC-_____). Using accounting

definitions derived from a recent Regulatory Assistance Project treatise,[11] the Coalition asked Avista for data on how much of the company's fixed-cost revenue requirement under the Settlement Stipulation would be recovered in variable energy charges. Avista's response shows that fully 80 percent of Avista's fixed-cost revenue requirement would be recovered in variable energy charges ($252 million out of $315 million). See Exhibit 2 (RCC-____). This means that every one percent reduction in electricity use on the company's Washington system would cut annual fixed cost recovery totals by more than $2.5 million; every one percent increase would have the opposite effect. Since many efficiency measures last ten years or more, these one-year impacts must be multiplied at least tenfold when assessing shareholder interests.

But the losses get even worse in the context of multi-year programs initiated under a long-term resource plan. Consider a five-year program that pursues annual savings equivalent to one percent of system load in the initial year, with each year adding new savings equivalent to the savings achieved during the previous year, and all savings persisting for at least five years. The first year impact on fixed cost recovery is then $2.52 million, followed by $5.04 million in the second year (as an equal amount of savings is added), and so on: **the automatic five-year loss to shareholders from this steady-state utility investment program would be almost thirty-eight million dollars**,[12] with shareholder losses continuing to escalate in succeeding years as initial electricity savings persisted (with some gradual erosion) and more savings were added. Note that the shareholders would be absorbing these losses even as society gained from substituting less costly energy efficiency for more costly generation.

Q. What makes you think Avista can sustain annual savings equivalent to one

[11] Regulatory Assistance Project, Revenue Regulation and Decoupling (June 2011).

[12] The minimum loss figure is the sum of $2.52 million + $5.04m + $7.56m + $10.08m + 12.60m = $37.80 million.

percent of system load, or indeed that the company could or would pursue incremental conservation if full decoupling were in place as you recommend?

A. On the issue of the one percent figure, I note that the Northwest Power Planning and Conservation Council set a somewhat more ambitious savings target for the region in its Sixth Power Plan (1200 aMW of savings by 2015, equivalent to 85% of projected load growth and about 1.2% of system load annually, with comparable or increased annual targets through 2030).[13] On the issue of the potential for incremental conservation, see Exhibit 1 (RCC-____) to my testimony, which shows that Avista's average electricity use per residential customer has barely budged since 2000 and actually increased in 2009 and 2010. If anything, one percent of system load per year is a conservative estimate of the savings that a fully mobilized utility could achieve in partnership with its customers. And I note that Avista relied on its share of the Council's Sixth Plan conservation potential assessment in setting its first biennial conservation target under Initiative 937 ("I-937").[14]

Q. Why do we need full decoupling for Avista to promote energy efficiency progress, when I-937 already requires the company to achieve all cost-effective energy efficiency?

A. The Commission's own Policy Statement begins with an invocation of I-937 (p. 3), notes the Washington legislature's continuing interest in better aligning shareholder and customer interests in achieving that objective, and concludes that "the Commission is receptive to applying a well-designed full decoupling mechanism for either electric or gas utilities." (p. 19). I agree with the Commission that the I-937 mandate does not moot the decoupling issue,

[13] See the summary of the Council's Sixth Regional Plan at http://www.nwcouncil.org/library/2010/2010-08.htm.

[14] RCW 19.285.040(1); Docket No. UE-100176.

and I believe that it is past time to ensure that Avista and other utilities are not automatically penalized for progress in achieving the worthy energy efficiency goals of I-937. In my opinion, full decoupling will increase the likelihood that these goals will be achieved, along with their extraordinary economic and environmental benefits.

V. RECOMMENDED ELEMENTS OF A FULL DECOUPLING MECHANISM

Q. Could you describe your proposed decoupling mechanism for Avista's electric revenues?

A. I recommend a straightforward form of per-customer decoupling based on the fixed-cost per-customer revenue requirement adopted for each customer rate class in this proceeding, with annual reconciliations of actual to authorized fixed cost recovery and subsequent rate true-ups for all participating customer classes. Any associated annual rate increases would be capped at 3 percent (no limit on reductions), with unrecovered balances carried forward. As with the per-customer decoupling mechanism that the Commission approved twenty years ago for Puget, I recommend "set[ting] up a deferred account allowing a reconciliation of revenue and expenses that would be subject to hearing and review."[15]

Q. Would shareholders automatically gain by substituting per-customer decoupling for the status quo, which effectively allows Avista's annual fixed-cost revenue requirement to grow in proportion to its retail sales instead of its customer count?

A. That would be true only if growth in the company's customer count typically outstripped its retail sales growth rate. In fact there is little difference between the two, based on the last 20 years of data on growth in Avista's electricity sales and customer count. Between 1991 and 2010, Avista's electricity sales grew by 29% and its customer count increased by 31%;

[15] See note 3 above.

if the focus narrows to the last decade, the comparable numbers are 11.5% and 12%. See Exhibits 3 and 4 (RCC-_____). In sum, a switch to per-customer decoupling does not appear to create any inherent advantage for shareholders compared to status quo practices, but it will remove a significant financial disincentive for energy efficiency progress. Moreover, a statistical analysis by Lawrence Berkeley National Laboratory of the impact of changes in sales or number of customers on nonfuel costs showed that "one-year changes in the number of customers have a fairly strong one-year impact on nonfuel costs but that one-year changes in sales have a rather weak effect."[16]

Q. What is the basis for the proposed three percent limit on any annual rate increases?

A. A three percent limit on any annual rate increase should provide customers with insurance against rate volatility while still allowing high confidence that the mechanism can function as designed without generating significant accumulating balances. The largest systemwide annual reduction in electricity use recorded by the company in the last twenty years was about 2.8 percent (from 1996-1997, as indicated in Exhibit 3 (RCC-_____); a significantly larger reduction would be needed in order to reach the rate impact limit, and of course any such rate increase would occur at a time when average bills were declining as consumption dropped.[17]

Q. Would you apply the proposed mechanism to all customer classes?

A. The Commission's Policy Statement indicates that "[g]enerally, a full decoupling

[16] J, Eto, S. Stoft, and T. Belden, "The Theory and Practice of Decoupling," Lawrence Berkeley National Laboratory, p. 32, 1994.

[17] A three percent reduction in systemwide consumption would imply less than a two percent decoupling-related true-up, since more than 40% of the resulting revenue reduction represents variable costs that are not included in the decoupling mechanism or fixed costs recovered other than through energy charges. For the fractions of energy charges representing Avista's fixed and variable costs, see Exhibit 2, (RCC-_____) to my testimony.

proposal should cover all customer classes" (p. 18), but also states that the Commission will consider alternatives "where in the public interest and not unlawfully discriminatory or preferential." I do not propose to include the Extra Large General Schedule 25 class in the mechanism, because it has so few members (22) and accounts for a relatively small fraction of the fixed cost revenue requirement that Avista recovers through its energy sales (about 10%, although the class accounts for almost 20% of retail electricity sales).

Q. Would you calculate separate decoupling adjustments for each class?

A. No, I would average the adjustments across all classes, to minimize administrative complexity, intra-class rate volatility and the likelihood that unrecovered balances will have to be carried forward for individual rate classes.

Q. Would you treat new and existing customers differently?

A. No, because it would increase the complexity of administration and because I am unaware of any compelling justification for vintaging of this kind. It is worth noting that neither the Oregon nor the Idaho electric decoupling mechanisms have this feature.

Q. Wouldn't this potentially result in inequitable results for some classes?

A. Only if opportunities for either lost or found revenues are not distributed with rough equality across the classes over time, which I do not believe to be the case.[18] Opportunities for inequitable outcomes are further reduced by the proposed cap of 3% on any decoupling-related rate increases, and the limited initial duration (five years) of the proposed

[18] From 2001-2010, for example, the three classes accounting for more than 95 percent of the electricity use covered by my proposed mechanism all showed consumption increases in a roughly comparable 4-10% range; the Pumping and Street and Area Lights were outliers over that period (showing a 38% increase and a 5% decrease, respectively), but they accounted for only three percent of covered electricity consumption in 2010. See Exhibit 3 (RCC-_____). And given their relatively small size, the outlier classes would benefit from the rate stability associated with the averaging approach that I recommend.

mechanism, as described later in my testimony. The simpler the administration of the mechanism and the lower the likelihood of unrecovered balances, the greater the benefits in terms of removal of barriers to energy efficiency progress.

Q. What about a weather adjustment mechanism?

A. I propose no application of any weather-adjustment to revenues for purposes of the true-up, in accord with the Policy Statement (p. 18). In other words, I recommend against weather-normalizing electricity sales and revenues prior to calculating the annual true-up; instead, like the Commission, I favor "including the effects of weather in a full decoupling mechanism." (id.).

Q. The Policy Statement indicates (p. 17) that a full decoupling mechanism "must include . . . a proposed earnings test to be applied at the time of the true-up." What is your recommendation?

A. I respectfully encourage the Commission to reconsider, since it is not obvious why removing the linkage between retail sales and fixed-cost recovery should hinge on the company's earnings. Moreover, a constraint of this kind serves as an obvious inhibition on the company's incentive to control costs, about which the Commission is rightly concerned (Policy Statement, p. 16). Decoupling would have no such effect per se, as explained further below, but linking any upward adjustments to subpar earnings certainly could. There is a much stronger rationale for including an earnings test in a partial decoupling mechanism, because its annual lost revenue awards otherwise would yield automatic rate increases, while leaving open the possibility that the company could asymmetrically pocket both "found" and "lost" revenues (see Policy Statement, p. 16, citing NRDC's concerns on this point). If the Commission nonetheless determines after further review to include an earnings test in a full decoupling mechanism for

Avista, I recommend that the Commission provide that the company will not recover any decoupling deferral amounts to the extent that the company would be earning more than 25 basis points above its authorized return on investment.

Q. How would you propose to address the Commission's concern about the potential that reduced fixed-cost recovery from lower retail sales could be partly or wholly offset by margins on increased off-system sales (p. 17)?

A. Avista's Energy Recovery Mechanism ("ERM") already responds to this concern; it is designed to net revenues from off-system power sales against production costs incurred by the company to generate those sales.[19] More specifically, the ERM tracks wholesale transaction volumes and wholesale prices, and restores to customers the difference between the wholesale price and a "retail revenue credit" that includes generation and transmission costs but not distribution fixed costs. In other words, the ERM is designed to transfer to customers any margin on wholesale transactions in excess of the company's generation and transmission costs.

Q. But doesn't the ERM include a deadband that could absorb some or all of those margins?

A. Yes, but the deadband obviously is there for reasons unrelated to revenue decoupling. The deadband presumably reflects a judgment by the Commission that the Company and its customers should share risks associated with wholesale transactions up to a certain level; if the Commission wants to revisit that balance I would have no objection, but I

[19] The Policy Statement refers to "the financial benefits associated with off-system sales or avoided costs attributable to the utility's conservation efforts" (p. 17), but, of course, a full decoupling mechanism does not attempt to differentiate among the causes of reductions in retail sales when calculating rate true-ups, so my focus is the extent to which that calculation should be adjusted to reflect net revenues from all off-system sales. If the ERM is structured to avoid double recovery of fixed costs through wholesale transactions, there is no need to try to identify how much wholesale revenue can be traced back to "the utility's conservation efforts."

don't think that retail revenue decoupling is relevant to the appropriate sharing of risks associated with wholesale power transactions.

Q. But couldn't the deadband result in double recovery of some authorized fixed costs under decoupling?

A. Conceivably, if the company found itself in the positive portion of the deadband as a result of wholesale power prices above its variable generation and transmission costs, and if it were simultaneously receiving an upward decoupling rate adjustment due to reduced retail sales (of course, the company could also suffer a double loss if the opposite conditions prevailed). If the Commission felt that this was a significant problem, it could, of course, net any upward or downward decoupling adjustments against the net fixed cost recovery within the deadband that the Company had reported pursuant to the ERM calculation.

Q. Does the ERM's retail revenue credit include fixed as well as variable costs of generation and transmission, and if so, how does application of the credit affect the contribution of wholesale transactions to fixed cost recovery?

A. My understanding is that the credit does include fixed costs of generation and transmission (although the version in the settlement proposal clearly excludes fixed costs of distribution).[20] Whether or not the Commission adopts decoupling, I believe that the retail revenue credit should reflect the variable costs of wholesale power sales, with all revenues exceeding those costs credited to customers. Again, however, this is not an issue that is affected by decoupling; it goes to the much broader question of how the ERM should net Avista's wholesale power revenues against its total variable power production costs in order to reflect

[20] See Settlement Stipulation, item 7 ("ERM Authorized Amounts") and Appendix I (retail rate credit); and Testimony of Tara L. Knox, Exhibit ___ (TLK-4), p. 2 (providing functional component cost summary).

accurately and fairly in retail rates the company's variable costs of electricity production.

Q. What about rate impacts of revenue decoupling, and in particular the potential impacts on low-income customers (Policy Statement, p. 18)?

A. The most important point to emphasize is that neither full decoupling in general nor my proposal in particular add any additional costs to low-income customers' bills; they simply ensure that previously approved fixed costs are neither over- nor under-recovered. If any party to this proceeding thinks low-income customers are paying too high a share of Avista's costs of service, decoupling does not add to the problem. In terms of rate adjustments needed to achieve decoupling of fixed-cost recovery from retail sales, experience shows that effects are minimal in practice, with adjustments that go in both directions. A comprehensive industry-wide assessment (Exhibit 5 (RCC-____)) found that, of 88 gas and electric rate adjustments from 2000-2009 under decoupling mechanisms, less than one-seventh involved increases exceeding 3 percent. (Refunds accounted for a much larger fraction.) Typical adjustments in utility bills "amount[ed] to less than $1.50 per month in higher or lower charges for residential gas customers and less than $2.00 per month . . . for residential electric customers."[21] For electricity, that represents about seven cents a day for the average household, which sometimes comes in the form of a rebate and serves only to ensure that the utility recovers no more and no less than the fixed costs of service that regulators have reviewed and approved. I recognize that low-income customers are struggling to make ends meet, which is why it is vitally important for Avista to target energy efficiency services and payments specifically to low-income customers (as emphasized also in the Commission's Policy Statement at p. 13), and to increase efforts to reach

[21] See Pamela Morgan, Rate Impacts and Key Design Elements of Gas and Electric Utility Decoupling: A Comprehensive Review, Electricity Journal (Oct. 2009), p. 67 (Exhibit 5 (RCC-_____)).

more customers who qualify for those programs. I note that Section 12 of the Settlement Stipulation appropriately includes additional attention to these important concerns.

Another way to advance low-income customer interests would be to apply any downward decoupling-related rate adjustments to the baseline block of residential consumption, while applying any upward adjustments to the higher-priced tailblock. This would benefit low-income customers, who tend to use less electricity on average, while also reinforcing the conservation incentives associated with Avista's inverted-block residential rate structure. This is not an essential feature of my proposal and I do not know if Avista's billing system will accommodate it immediately; the alternative is simply to spread rate true-ups equally across all residential kWh sales.

Q. What do you recommend regarding the duration of the mechanism?

A. I recommend that the Commission establish a five-year duration, to allow time for the mechanism to influence utility planning and show results.

Q. How should the Commission evaluate the mechanism?

A. I recommend an independent evaluation, using a contractor selected by the company and Commission Staff early in the implementation process after consultation with all interested parties. The evaluation should be based on the first four years of data, so that findings are available before the mechanism expires. I also recommend that Avista file annual progress reports on rate impacts and energy efficiency progress, available to all interested parties (see Policy Statement, p. 19). The report filed in each even-numbered year could be part of Avista's biennial reporting requirement under I-937, due by June 1; in odd-numbered years, the company could follow its ongoing practice of submitting annual reports in the spring, as outlined in the Commission's Order 01 in Docket No. UE-100176.

Q. How would you recommend addressing "the impact of the proposal on risk to investors and ratepayers and its effect on the utility's ROE" (Policy Statement, p. 17)?

A. My view is that the company should pass through to customers any cost savings associated with changes in its capital structure following adoption of the decoupling mechanism (e.g., a shift in the equity/debt ratio). This reflects what I understand to be the Commission's position in the Policy Statement about flowing reductions in debt and equity costs through to utility customers (p. 16).

Q. Explain your conclusion that approving the Coalition's proposal should not result in a prospective adjustment in Avista's authorized return on equity.

A. The data that I summarized earlier from Pamela Lesh Morgan's comprehensive survey provide the strongest support for my recommendation (see also Exhibit 5 (RCC-____)); rate impacts this modest simply do not imply appreciable consequences for company-wide cost of capital, and I have seen no empirical evidence to the contrary. Indeed, in the specific context of natural gas utility decoupling, a March 2011 investigation by the Brattle Group reached the opposite conclusion:

> The findings of our analysis do not support the belief that utilities with decoupling have a lower cost of capital than utilities without decoupling. Contrary to what some might expect to find, at least on the basis of the opinions of certain intervenors and the (minority set of) judgments where commissions reduced allowed rates of return because of decoupling, we found that the estimated cost of capital for decoupled utilities was higher by a small but statistically significant amount (emphasis in original).[22]

In light of this evidence, I agree with the Arizona Commission's recent conclusion that "Commitment to and early implementation of decoupling should precede significant decoupling-specific adjustments to cost of capital if a revenue per customer decoupling mechanism is

[22] J. Wharton, M. Vilbert, R. Goldberg & T. Brown, The Impact of Decoupling on the Cost of Capital (Discussion Paper, The Brattle Group, Mar. 2011), p. 2.

approved for a utility."[23] I also agree with the Regulatory Assistance Project that, to the extent decoupling makes possible changes in utilities' capital structure that reduce total costs to customers, those savings can and should be passed through to customers once achieved.[24]

Q. How should the Commission assess whether any such changes in costs to customers have occurred?

A. Such an analysis could be conducted as part of the recommended evaluation of the mechanism. Allowing the mechanism to operate for five years should allow sufficient time for changes in cost of capital to emerge.

VI. THE BROADER CASE FOR ELECTRICITY DECOUPLING

Q. How many states have adopted full decoupling mechanisms for electric or natural gas utilities?

A. Nationally, the count of states with full decoupling for at least one utility stands at 14 for electricity and 22 for natural gas. In the West, Hawaii, California, Idaho and Oregon have adopted full decoupling for at least one electric utility. California, Utah, Oregon, and Wyoming have adopted full decoupling mechanisms for natural gas. Arizona's Corporation Commission has adopted a Final Policy Statement endorsing full decoupling for both electric and natural gas utilities.[25] New Mexico's Public Service Commission has left open "the determination of whether a decoupling mechanism should be approved or required for any utility," and the New Mexico Legislature has acknowledged the need to "identify regulatory disincentives or barriers

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[23] Final ACC Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314 (Dec. 29, 2010), p. 31 [item 6].

[24] See Regulatory Assistance Project, Revenue Regulation and Decoupling: A Guide to Theory and Application (June 2011), pp. 36-41.

[25] Final ACC Policy Statement, note 23 above.

for public utility expenditures on energy efficiency and load management measures and ensure that they are removed in a manner that balances the public interest, consumers' interests, and investors' interests."[26]

Q. What do you say to those who are concerned that revenue decoupling reduces incentives to save energy, by raising rates and depriving customers of rewards from consumption reductions?

A. Experience proves the opposite. Revenue decoupling results in very modest rate adjustments that go both ways, and do not materially affect rewards to consumers for reducing their use of electricity and natural gas. As the Oregon Public Utility Commission found when it adopted a decoupling mechanism for Portland General Electric in January 2009, responding to analogous claims that decoupling would rob customers of the rewards of conservation: "We believe the opposite is true: an individual customer's action to reduce usage will have no perceptible effect on the decoupling adjustment, and the prospect of a higher rate because of actions by others may actually provide more incentive for an individual customer to become more energy efficient." Oregon PUC Order No. 09-020, p. 28 (Jan. 2009). Finally, note that unlike so-called "fixed-variable rate designs" that load fixed costs into monthly customer charges, my proposal does not establish a 'fixed bill' that would make customers indifferent to the amount of electricity that they use.

Q. Doesn't your decoupling proposal result in paying Avista for savings that it didn't help achieve?

A. No, because the proposed mechanism doesn't "pay" Avista any incremental amount for anything; it is simply a mechanism that allows the company to receive no more and

[26] See Case No. 08-00024-UT, Final Order Repealing and Replacing 17.7.2 NMAC (2010), p. 10; Efficient Use of Energy Act, Section 62-17-5.F.

no less than the fixed-cost revenue requirement per customer that the Commission has reviewed and approved.

Q. Revenue decoupling has been criticized as "use less, pay more" and shifting risk to customers; do you believe those are valid concerns regarding your proposal?

A. No. As indicated earlier in my testimony, customers who find ways to use significantly less energy will not be appreciably affected by decoupling-induced rate adjustments, and of course a principal justification for the company's energy efficiency programs is to reduce the costs of providing reliable energy services, with long-term bill reductions for Avista customers (reflecting reductions in the company's revenue requirements and fuel purchases) that revenue decoupling will not affect. With regard to risk shifting, an appealing feature of the proposal is that it reduces risks for *both* customers and shareholders; customers get prompt relief from cost increases driven by extreme weather events, and Avista avoids downside risk on recovery of its authorized fixed costs (although, as noted earlier, I do not view this as justification for a prospective reduction in the company's ROE). Risk reduction is not a zero sum enterprise here.

Q. Why not simply pay Avista the fixed costs determined to have been lost as a result of electricity savings achieved by its energy efficiency programs?

A. That was indeed essentially what Avista itself proposed in the Direct Testimony of Patrick Ehrbar, which advocated an "Energy Efficiency Load Adjustment" (pp. 38-47). In its support for the Settlement Stipulation, Avista rightly abandoned this proposal, which represents the very kind of lost revenue recovery mechanism whose deficiencies are addressed in the Commission's Policy Statement (pp. 7-8). It would result in automatic penalties, in the form of reduced fixed-cost recovery, for all cost-effective electricity savings not directly associated with

the company's "programmatic energy efficiency efforts." Cost-effective savings in this category include those from efficiency standards administered by government agencies, which can benefit greatly from utility support; informal intervention by utility staff to encourage customer patronage of independent energy efficiency contractors; and effective public education campaigns with multiple participants, including utilities. The Energy Efficiency Load Adjustment would also have created a powerful and perverse new incentive for the company to promote programs that looked good on paper but delivered little or no savings in practice (because then the Adjustment would deliver double recovery). For example, poorly designed efficiency measures that customers later replaced or disconnected might well result initially in lost revenue recovery, while allowing the utility also to gain later from higher energy sales after the measures ceased to function. By contrast, revenue decoupling removes any prospect of that wholly inappropriate upside opportunity for the utility when efficiency measures fall short for any reason. Moreover, the Load Adjustment would leave unimpaired strong utility incentives to promote increased electricity use, since (unlike the full decoupling proposal presented here), Avista would keep any fixed cost recovery in excess of that authorized by the Commission. Paying utility bonuses for both increases in its retail electricity sales and its programmatic electricity savings is the metaphorical equivalent of encouraging the CEO to drive with one foot on the brake and the other on the accelerator. Finally, the Load Adjustment would have yielded an automatic rate increase, whereas rate adjustments under full decoupling can be either positive or negative (see Pamela Lesh Morgan's review of 88 decoupling adjustments across 45 utility systems nationwide, which is attached as Exhibit 5 (RCC-____).

Q. Where has decoupling helped support aggressive investment in cost-effective energy efficiency?

A. In 2010, seven of the ten states with the highest per-capita investment in electric energy efficiency programs[27] and eight of the ten states with the highest per-capita investment in natural gas energy efficiency programs[28] had decoupling mechanisms in place or had adopted decoupling as state policy. Washington State is often and appropriately credited as a pioneer in electric decoupling, and this testimony is an appeal to return to a proven approach that this Commission first road-tested two decades ago.

Q. Does decoupling benefit all customers?

A. In the short term, because decoupling can produce both refunds and surcharges for customers, decoupling alone has no predictable effect on customers, including those who have already invested in energy efficiency or those who use little energy. Over the long term, decoupling benefits all customers by clearing the way for energy efficiency investments that: (i) reduce peak and overall demand for energy, (ii) delay the construction of costly new generation capacity or pipelines, (iii) reduce demand for underlying fuels and put downward pressure on commodity prices,[29] and (iv) reduce pressure on the transmission and distribution system, reducing the likelihood of costly outages and delaying the need for costly upgrades.

Q. Should concerns that decoupling is "single-issue ratemaking" prevent the Commission from adopting your proposal?

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[27] The states are: California, Connecticut, Idaho, Massachusetts, New York, Oregon, and Vermont. See "State of Efficiency Program Industry Report," Consortium for Energy Efficiency, Table 6, January 12, 2011, http://www.cee1.org/ee-pe/docs/Table%206.pdf.

[28] The states are: California, Massachusetts, Minnesota, New Jersey, New York, Oregon, Utah, and Wisconsin. See "State of Efficiency Program Industry Report," Consortium for Energy Efficiency, Table 9, January 12, 2011, http://www.cee1.org/ee-pe/docs/Table%209.pdf.

[29] A study by the American Council for an Energy-Efficient Economy concluded that increasing energy efficiency by 5% could reduce natural gas prices by 20%. N. Elliott, A. Monis Shipley, S. Nadel, and E. Brown, "Impacts of Energy Efficiency and Renewable Energy on Natural Gas Markets," American Council for an Energy Efficient Economy (Sept. 2003).

A. No. "Single issue ratemaking" usually refers to the increase of rates between rate-setting processes based on an increase in a single cost driver, without taking into account other factors that could offset a utility's increased costs. Decoupling mechanisms that use revenue requirements authorized by the Commission in a rate case, with no attempt to change them in subsequent years to take cost drivers into account, are certainly not single issue ratemaking.

Q. Is decoupling an example of "retroactive ratemaking?"

A. No. Decoupling is not "retroactive ratemaking" because it compares actual revenues to the revenues authorized by the Commission in a rate proceeding, or the revenues produced by an approved formula that takes into account important cost drivers. Decoupling rate adjustments are the result of the application of a fully adjudicated method for changing rates, and the rate adjustments can go in both directions. Ken Costello of the National Regulatory Research Institute has investigated whether decoupling mechanisms meet the traditional tests justifying state utility regulators' use of "tracking mechanisms that adjust rates and revenues whenever sales deviate from their targeted level," and has concluded that "[u]nless a commission faces legal restrictions in implementing a 'sales tracker' or has a built-in policy of limiting trackers in general, [revenue decoupling] would seem to meet the regulatory threshold for a tracker."[30]

Q. Could decoupling increase rates for customers if they conserve energy during an economic downturn?

A. In an economic downturn with an associated decrease in utility sales, *rates* of a utility operating with decoupling may temporarily increase while *bills* for conserving customers will decrease because of their lower consumption. With or without decoupling, decreases in sales due to economic downturns are likely to result in rate increases, since utilities must act to

[30] K. Costello, "Briefing Paper: Revenue Decoupling for Natural Gas Utilities," National Regulatory Research Institute, Apr. 2006, p. 9.

maintain revenue to cover their fixed costs at the new, lower level of sales. But without decoupling, rates will almost never *decrease* when sales are higher than expected due to economic recovery, weather, or other factors. Decoupling protects customers from paying utilities more than necessary to enable them to recover their authorized fixed costs.

Q. Does decoupling guarantee profits or affect a utility's incentive to control costs?

A. No and no. I agree with the Regulatory Assistance Project that "[i]n fact, precisely the opposite is true."[31] Decoupling provides assurance to a utility and its customers that the utility will recover only its authorized *revenues* (that is, the amount that regulators have already determined is necessary and prudent in order to deliver energy services to customers). A utility's profit will continue to be driven by both its revenues and its costs, as well as other regulatory decisions that determine the utility's authorized rate of return on capital. Without decoupling, profit is tied both to sales growth and cost control. With decoupling, controlling costs takes on even greater importance since the utility can no longer increase profits by increasing sales. This should remove any "lingering concerns regarding possible reduced incentives for companies to manage in an efficient manner," which the Commission noted in its Policy Statement (p. 16).

Q. Does this conclude your testimony?

A. Yes.

[31] Regulatory Assistance Project, note 11 above, p. 45.