BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

DOCKET NO. UE-991606
DOCKET NO. UG-991607

REBUTTAL TESTIMONY OF THOMAS M. MATTHEWS
REPRESENTING THE AVISTA CORPORATION

Exhibit T-___ (TMM-T)

I. INTRODUCTION

Q. Please state your name, business address and position with Avista Corporation?

A. My name is Thomas M. Matthews. My business address is East 1411 Mission Avenue, Spokane, Washington. I am Chairman of the Board, President, and Chief Executive Officer of Avista Corporation (Company).

Q. Have you previously submitted direct testimony in this proceeding?

A. Yes, I have. In that testimony I provided a brief overview of the Company's rate filing and generally described the Company and its various lines of business.

Q. Are you sponsoring any additional rebuttal exhibits in this proceeding?

A. Yes. I am sponsoring Exhibit No. ____ (TMM-1), which was prepared by me or under my direction and supervision.

Q. What is the purpose of your rebuttal testimony in these proceedings?

A. I will provide general comment with regard to the staff and intervenor cases, highlighting the troubling message that the position of staff and intervenors sends to a number of constituencies, including employees, shareholders, and the communities in which we serve. Other witnesses, on behalf of the Company, will address, in detail, each of the adjustments proposed by staff and intervenors.

Q. In general, what has the staff proposed in its filing?

A. Staff and intervenors reject the need for rate relief, with staff arguing for a $16.4 million <u>decrease</u> in revenue requirement for electric operations. This compares with the Company's initial request for an <u>increase</u> of approximately

$26.3 million. The differences between staff/intervenors and the Company are many, presenting approximately seventy different issues. A wide gulf separates the philosophy, approaches, analysis of data and conclusions of staff/intervenors and the Company on several key issues, including power supply, use of the so-called PGE monetization cash proceeds, reasonable rate of return, and miscellaneous accounting adjustments.

With respect to cost of capital, the Company proposed a 12.25% return on equity (with an overall rate of return of 9.93%) with a 47% common equity component. Staff, on the other hand, proposed only a 10.40% return on equity (overall rate of return of 8.2%), based on a 42% common equity component. This is not reflective of returns allowed for a similarly-situated peer group of companies, as testified to by Dr. Avera and Mr. Eliassen. Moreover, staff proposed numerous power supply adjustments, with the staff seeking to overstate and capture all commercial trading margins (while ignoring the risk), opposing a power cost adjustment (PCA) mechanism and, notably, excluding replacement power costs associated with the recently-approved Centralia plant sale (after more than 80% of the gain above book value was to be passed through to ratepayers). Staff also refused to use water data in hydro-dispatch

models that have been adopted by the BPA, the Northwest Power Planning Council, the Northwest Power Pool, and in adjacent states such as Idaho.

Furthermore, staff filed a case that assumed that the PGE monetization cash proceeds should have been used to essentially renegotiate and eliminate the lease expense associated with the Rathdrum Turbine, should have offset the buyout of the Wood Power, Inc. contract, should have been used to reduce the Potlatch purchased power costs, and should have been used for a variety of other rate base reductions, including the elimination of any remaining DSM balances. This ignores the fact that these existing rate-based items were prudently incurred.

In addition, staff and intervenors have rejected a number of accounting adjustments, including the recovery of an amortized amount of 1996 ice storm damage repair costs, administrative expenses associated with the Company's nationally-recognized and lauded hydro-relicensing efforts, name change costs (when the utility adopted the subsidiary's name), and expenses associated with necessary Y2K efforts — even though the Company was recognized by the State as a model for Y2K preparedness. The staff also proposed the elimination of bonus and team incentive payments made throughout the Company, and the elimination of any Kettle Falls environmental "adder," even though authorized by statutes in this State. Also, when recommending a reduction in executive salaries, staff and intervenors would, without sound analysis or a broader perspective, substitute their judgment for that of our Board of Directors and our own expert compensation consultants. Again, these and other issues will be addressed by later witnesses.

Suffice it to say, the Company has a profoundly different view than the staff and intervenors when it comes to appropriate rate-making treatment in this proceeding.

Q. What is the impact of the staff's proposed decrease of $16.4 million of revenue requirement on each of the several constituencies, beginning with employees?

A. Such a proposal sends a very discouraging message to the 1,500 employees who work within the utility. This Company, beginning before my arrival, has made a concerted effort through all of its employees to manage costs and provide safe and reliable service in the process. This Company, through the efforts of its employees, has managed to avoid the need for general rate relief over the past twelve years. Since 1987, electric rates have gone up by only 3.5%, as compared with the CPI Index and COLA, which have gone up by approximately 47% during the same time period. Rates have remained unchanged for approximately ten years; inflation has not. Exhibit _____ (TMM-1) shows this information graphically. Our employees, as I mentioned, have worked wonders to control costs. For example, the number of customers per employee numbered 278 in 1990; by 1998 that number had increased to 390 customers per employee.

In the process, the Company has been nationally recognized for its low costs, low rates, high efficiencies, outstanding customer service and environmental performance — and yet, these accomplishments and the efforts of our employees are apparently discounted by staff and intervenors.

Q. What message does the staff/intervenor case send to employees who have worked so hard to achieve national recognition for this utility?

A. A very disheartening one. As you will recall, in the direct testimony of Mr. Dukich, the Company recounted a number of achievements over recent years. There was, for example, a 1997 study of 94 U.S. electric utilities in which the Company was rated second in terms of competitive efficiency, (with a rating of 99.9%). Another study by Public Utilities Fortnightly, ranked the Company in a tie for fifth place in terms of overall efficiency. Yet another survey by Theodore Barry and Associates, Inc., ranked the Company number one out of 34 national utilities in terms of overall costs, customer service, and number two in low cost of service when combined with overall customer satisfaction. Previous testimony presented in this proceeding demonstrated that our customer call center was rated the number one call center in the nation in 1999. Similarly, our hydro-relicensing effort, resulting in a very cost effective settlement for the Company's ratepayers, has won national recognition. All the while, our rates remain the fourth lowest in the nation; and even with the full amount of rate relief of $26 million, the Company would still be in the lowest 10 out of 177 utilities surveyed.

These are all accomplishments that the employees should be proud of — and they justifiably are. These accomplishments should also serve as a source of some pride for those who regulate us. In short, the employees of this organization have created a history and a list of accomplishments that place it among the premier service providers in the nation.

What, then, is the message being sent to our employee base, with the staff proposal. Mr. Lurito's testimony, on behalf of the staff, for example, curtly dismisses the Company's argument for a 25 basis point "adder" in order to recognize the Company for its innovative management and strategic initiatives:

> "<u>The fact is that the Company is an irrelevant player in this whole matter</u>. There are only three players at issue: consumers, <u>existing</u> investors, and management. If the commission allows the 25 basis point markup, it is clear who pays: consumers. . . . In view of all this, it is clear that the only possible rationale for allowing the markup is to accomplish a transfer of wealth from consumers to management." (See Exhibit ___, (RJL-T), p. 31, emphasis added).

In fact, the Company is not "an irrelevant player" as Mr. Lurito suggests. The Company — made up of its employees — has accomplished a great deal and will accomplish a great deal more. It is ludicrous to even infer that our employees, who make up the Company, constitute "an irrelevant player."

Equally absurd is the notion that the "only possible rationale" for the approval of an equity adder for innovative strategies is to accomplish the "transfer of wealth" to management; Mr. Dukich, a later witness, will speak to this point.

Q. Is there another example of a particular message being sent to the employee base?

A. Yes. Staff witness Huang would eliminate most of the "team incentive awards" that had been distributed during the test period. The majority of our employees participated in these awards, which were meant to recognize and promote the sort of performance that has won this Company national acclaim. And yet, without any real analysis of the purpose served by such awards, staff has greatly reduced this test period expense, simply relying on historical calculations of what prior incentive levels had been. Again, as this Company moves forward into the next century and meets the demands of a rapidly changing utility environment, it needs to recognize and reward its employee base in new and innovative ways. Staff and intervenors apparently do not fully appreciate that compensation strategies, including the greater use of incentive payments, are rapidly evolving in the energy and utility business, as testified to by Company witness Feltes.

Q. You previously mentioned that there was also an impact of the message on the communities in which Avista serves. Would you please elaborate?

A. In Eastern Washington and Northern Idaho, the accomplishments and future possibilities of Avista Corporation are something to cheer about. The success and drive of Avista is providing the "growth engine" for Eastern Washington. Our local communities take some measure of pride in what has already been accomplished by a corporation such as Avista, headquartered in Spokane. Avista is an active member of the community in which it serves and the leading promoter of charitable/civic/educational efforts. It provides

exciting employment opportunities within the utility and throughout its various subsidiaries. Avista attracts national attention to the area, by virtue of its many accomplishments as an utility (e.g., call center awards, hydro-relicensing, lowest rates, highest efficiency ratings in national surveys); in addition, the national attention surrounding its technology and information initiatives is already well known: Avista Labs and its fuel cell technology; Avista Advantage and its internet-based business management program; Avista Communications and its growing small community CLEC business.

While Avista is the leading supporter of the communities in which it serves, it also receives strong support and encouragement back from those same communities. I believe we are respected for our commitment to drive economic growth within our region, with our commitment to diversity in the workplace and with our major support of charitable, educational and civic endeavors.

All of this having been said, if staff has its way, the Company will be entirely rebuffed in its need for necessary rate relief — indeed, the staff would have the Company reduce its rates by approximately 6%. This will have an impact on our programs noted above. I believe that our communities and our ratepayers understand that, after ten years of no rate increases for electric service, there is a need for rate relief — especially in the face of inflationary increases of approximately 47% for the same period.

Q. Will the impact of increasing overall electric rates by 10.6% be understood by the Company's customers?

A. The need for an increase of this magnitude (which includes a somewhat higher increase of approximately 14% for residential customers in particular) is, I believe, generally understood by our customer base. Our customers understand that no business can hold prices constant indefinitely.

I believe they understand that, after ten years of no rate relief (while we have continued to build and improve our energy delivery system), something has to happen — especially in light of inflationary increases over the same period.

I should note that at the public hearing scheduled in these proceedings, only five members of the public chose to testify against the Company's rate request. While this is by no means a precise measure of customer opposition, it does suggest that there is no public outcry against the Company's proposed rate request.

Q. You have talked about the message being sent to employees, the communities, and the Company's customers. What about shareholders?

A. Of course, this Commission needs, and is required to appropriately balance the interest of all of these constituencies, including shareholders. That is what the law requires. It is "in the public interest" to have a robust utility that can provide safe and reliable service, doing so efficiently and cost-effectively. We have to look no further than Standard and Poor's recent CreditWire announcement of May 9, 2000, in which it stated that it was revising its outlook on Avista's debt from "stable" to "negative," noting:

> The financial position [of Avista] may be further weakened at the regulated level if the Washington

Utilities and Transportation Commission (WUTC)

> adopts a rate order comparable with the rate reduction recommended by its staff in the amount of $16.5 . . . An adverse ruling by the WUTC, in line with the staff's recommendation, would further hamper financial performance, possibly leading to lower ratings, Standard and Poor's said. (Emphasis added)

Even the filing of staff and intervenor cases which advocate an extraordinary rate reduction — thought not yet acted upon by the Commission — can have (and has had) an effect in the markets in which the Company must raise capital.

There should be no disagreement that rates need to be set at levels sufficient to provide a fair return on investment dedicated to serve customers and to provide for the recovery of prudently incurred costs. We have previously presented testimony in these proceedings indicating that the Company's test period proforma rate of return was only 7.51% — well below a fair rate of return by anyone's measure, and well below the economic returns earned by other viable businesses in this State over the last decade who compete for the same capital. I believe it is important to have a supportive regulatory climate in all states in which the Company serves, as we approach the challenges of the next decade. The regulatory support we have had in the past has provided a good foundation to build upon. The message we need to send to the shareholders and the investment community at large is that we still have the support of our regulators as we move forward in uncertain times, and that the capital allocated to the utility business will receive fair returns. Stated

differently, I believe there is a need to affirm to financial analysts that traditional rate base regulation is still supportive of our efforts.

Q. Has the Idaho Commission recently afforded the Company rate relief?

A. Yes. In a general electric rate proceeding just last year, the Idaho Commission awarded $9.3 million dollars of rate relief to the Company, representing almost 70% of the total request of $14.2 million dollars. I understand and appreciate that each Commission must, on its own, evaluate the Company's proposals and reach its own conclusions. Nevertheless, the very filing of a staff and intervenor case suggesting substantial revenue requirement <u>reductions</u> in Washington, is, I believe, perceived by outside observers as a "disconnect" with business realities.

Q. Understanding that other Company witnesses, on rebuttal, will address specific issues, do you nevertheless have additional comments about particular adjustments?

A. Yes, I do. I previously mentioned the approximately 70 different issues on which Staff/intervenors and the Company differ. It is, as if, Staff and intervenors simply add all of the adjustments — big and small — together to arrive at a $16.4 million decrease, without ever analyzing or addressing the question of whether this is a "<u>fair end result</u>," given the context. That context is one in which, as I have described, this Company has not had general rate relief for more than a decade; its rates are among the very lowest in the nation and would remain so even after the requested increase; inflation has increased by nearly 50% at the same time; and it has achieved numerous state and national awards for efficiency and customer service. At the end of the day, one is left to ask the question: Does such a staff/intervenor proposal "make sense" given this context? As I have testified above, many of our constituencies think it does not.

How in the world, for example, could staff disallow all Y2K-related costs, even though the Company only used test period costs and then normalized those over a five-year period. Our efforts for Y2K preparedness were, after all, a model for other State efforts. How, in heaven's name, could, for example, the staff reject the cost of necessary replacement power in the immediate aftermath of this Commission's approval of the Centralia sale, and after the commission had already directed that more than 80% of the gain above book value on the sale be given to ratepayers — not shareholders. These and dozens of other questions will be addressed by other witnesses on rebuttal.

Q. Does that conclude your rebuttal testimony?

A. Yes, it does.