BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-06_____

DIRECT TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

A. My name is Kelly O. Norwood. I am employed as the Vice-President of State and Federal Regulation for Avista Corporation at 1411 East Mission Avenue, Spokane, Washington.

Q. Please briefly describe your educational background and professional experience.

A. I am a graduate of Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. I joined the Company in June of 1981. Over the past 24 years, I have spent approximately thirteen years in the Rates Department with involvement in cost of service, rate design, revenue requirements and other aspects of ratemaking. I spent approximately eleven years in the Energy Resources Department (power supply and natural gas supply) in a variety of roles, with involvement in resource planning, system operations, resource analysis, negotiation of power contracts, and risk management. I was appointed Vice-President of State & Federal Regulation in March 2002.

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

A. In its Order No. 05, dated December 21, 2005 (Docket No. UE-050482), the Washington Utilities & Transportation Commission (WUTC) required Avista to make a filing on or before January 31, 2006 to initiate further review of the Energy Recovery Mechanism (ERM). My testimony will provide an overview of Avista's request in this filing to continue the existing ERM mechanism, with two proposed modifications, and will explain why the Company's proposal is in the public interest. The first modification is to eliminate the $9 million "deadband," as Avista proposed in its March 30, 2005 general rate case filing in Docket No. UE-

050482. The second modification is to add transmission revenue and expense components to the ERM calculations. This second modification is in response to recommendations made by Public Counsel in Avista's recently-completed general rate case. I will also introduce other witnesses sponsoring testimony on behalf of Avista.

Q. Are you sponsoring any exhibits with your testimony?

A. Yes. I am sponsoring Exhibit No. _____ (KON-2), which was prepared under my direction.

Q. Please introduce the other Avista witnesses, and briefly explain what their testimony will cover.

A. The following additional witnesses are presenting testimony on behalf of Avista.

Ms. Julie Cannell, President of the advisory firm, J.M. Cannell, Inc., is a former securities analyst covering utilities in the energy industry, and former equity portfolio manager with oversight of an equity utility mutual fund, and numerous institutional equity portfolios. Ms. Cannell has been asked by Avista to discuss the perspective of investors with respect to the continued need for the ERM, and the proposed elimination of the $9 million deadband. She will explain that investors have many choices in where they invest their funds, and for those that choose to invest in the utility industry, the effectiveness of the ERM can make a difference in whether they choose to invest in Avista.

Mr. Malyn Malquist, Sr. Vice President and Chief Financial Officer for Avista, will address the importance of the ERM mechanism in the Company's continuing efforts to fully regain its financial health, and more specifically to regain an investment grade credit rating. He will explain that, although the ERM has provided improvement in the recovery of power supply costs in recent

years, the combination of persistent below-normal hydro-electric conditions for four of the last five years, high natural gas prices, and the existence of the $9 million annual deadband have continued to undermine the Company's efforts to regain its financial health. Mr. Malquist will explain the importance of both the continuation of the ERM mechanism, and the elimination of the $9 million deadband.

Mr. Ron Peterson, Vice President of Energy Resources for Avista, will provide an overview of the electric resources used by Avista to serve its retail customers. He will explain the significant variability of power costs experienced by Avista due primarily to variations in streamflow for hydroelectric generation, and the variability of wholesale electric and natural gas prices. He will explain why the ERM mechanism is even more important today than it was in the past.

Mr. Bill Johnson, Sr. Power Supply Analyst for Avista, will describe the ERM methodology, and the Company's proposal to include certain transmission revenues and expenses in the ERM. His testimony and exhibits will also discuss the authorized (or base) level of power supply revenues and expenses used in the monthly ERM deferral calculations.

Mr. Ron McKenzie, Manager of Regulatory Accounting for Avista, addresses the accounting associated with the power cost deferrals under the ERM, and the monthly ERM reports that are provided to the Commission and to other interested parties. Mr. McKenzie also provides testimony explaining how the rate used for the Retail Revenue Credit component of the ERM is determined.

Q. Before you provide further detail of the Company's request in this filing, do you have any general comments regarding the ERM mechanism and the recent Settlement Agreement in Docket No. UE-050482?

A. Yes. The Settlement Agreement was a negotiated package that included give and take by the parties to the Agreement. In developing any settlement, it is understood that some revenue and expense items could arguably be higher or lower, but there is recognition that there are both "pluses" and "minuses" that tend to offset one another in arriving at a negotiated end result, as well as the fact that some of the elements are interrelated. As an example, Avista agreed to a natural gas price for gas-fired generation of $7.25/MMBTU as part of the Settlement package, knowing that the forward price of natural gas at the time was greater. The Company agreed to this price with the understanding that the reduction of the deadband to $3 million would somewhat limit the costs absorbed by Avista that might result from higher natural gas prices. The conditions imposed by the Commission furthered reduced the revenues to the Company from the Settlement by $748,000 (from $22,135,000 to $21,387,000), as well as reverted to the $9 million deadband instead of the $3 million in the Settlement. The agreed-upon return on equity of 10.4% also assumed a reduced deadband, and reflected a balancing of risks.

Therefore, the end result from the case, based on expected conditions for 2006, will yield financial results for the Company that are substantially different than what was intended by the parties to the Settlement, i.e., potentially absorbing an additional $6 million through the deadband, and the further reduction of revenues of $748,000. Although the Company chose to accept the conditions ordered by the Commission related to the Settlement Agreement, the acceptance was with the hope that this filing would provide the opportunity to restore the balance of interests that was achieved through the significant effort that went into the development of the Settlement Agreement.

II. PURPOSE OF THE ERM

Q. What is the ERM mechanism designed to do and why is it so important to the Company?

A. The purpose of the ERM is to provide more timely recovery of power supply related costs, and improve the stability of cash flow and earnings for the Company. This stability is very important to equity investors and lenders, as Ms. Cannell and Mr. Malquist will explain later, and is especially important to Avista at the present time for a number of reasons.

First, Avista's heavy reliance on hydroelectric generation as well as its ownership of gas-fired generation results in a significant amount of variability in its power supply operating costs, as Mr. Peterson explains in his testimony. This variability has been exacerbated in recent years as the wholesale price of electricity and natural gas has risen and become more volatile. As an example, with wholesale electric prices averaging approximately $60/MWH, only a 10% reduction in Avista's hydro generation would reduce the Company's Washington electric pre-tax operating results by $18 million.[1] This $18 million negative impact ($12 million after-tax) would represent over one-third of Avista's Washington electric earnings opportunity of $33 million.[2] Indeed, the Commission, at paragraph 72 of its recent Order No. 05 in Avista's rate case (Docket No. UE-050482), explicitly recognized that "[t]he deadband feature of the ERM has subjected the Company to greater earnings volatility than would a more simple mechanism or one with a smaller deadband."

In addition to this variability, the volatility of natural gas prices has created significant variability in the costs to operate Avista's gas-fired generation. The variability of these costs is

substantially greater than in the years prior to the 2000/2001 energy crisis when wholesale electric and natural gas prices were much lower and less volatile, and therefore the ERM is much more important today than it was in the past.

Furthermore, because the Company, the Commission Staff and all other parties to a rate proceeding are unable to predict with any degree of accuracy what future hydroelectric conditions or wholesale market prices will be, it is very difficult to determine an accurate level of power costs to include in base retail rates. To the extent that the power costs in base rates are not set correctly, an effective tracking mechanism, such as the ERM, would make adjustments so that the Company is able to recover its costs, and customers will not over-pay or under-pay as these costs fluctuate. Recent experience has repeatedly shown that the power costs included in base rates have been too low, and because of the $9 million deadband, the Company is continuing to absorb $9 million per year in costs, prior to being able to defer costs for recovery.

III. NEED TO ELIMINATE THE DEADBAND

Q. Why is the elimination of the deadband so important to the Company?

A. Repeatedly absorbing the $9 million deadband every year is undermining the Company's ability to regain its financial health. As Mr. Malquist explains in his testimony, Avista has a significant amount of debt that must be refinanced in 2007 and 2008. It is important to regain an investment grade credit rating prior to that time in order to refinance the maturing debt at lower interest rates. In addition, Avista's capital budget for the next two years (2006-2007) is expected to be $330 million (average of $165 million per year). This is well above prior

[1] Hydroelectric generation of 538 AMW x 10% x 8760 hours x $60/MWH x the 65% WA jurisdictional share = $18

years where the capital budget averaged approximately $110 million per year (10-year average of 1995-2004).

Increased financial stability, through elimination of the deadband, would be viewed positively by lenders and investors as we go through this period of intensive capital investment, and the refinancing of debt. This would enable Avista to attract capital under more reasonable terms, and will be beneficial to customers through lower financing costs over time. It will also improve the Company's ability to withstand difficult financial circumstances in the future.

The objective of ratemaking is to include in base retail rates the level of power costs that will allow the Company to recover its costs to provide service. There was a significant amount of testimony in the recent case related to the determination of the "correct" level of power supply costs. As I have already explained, current estimates show that natural gas costs in 2006 for thermal generation are higher than that included in base retail rates. And, in fact, our current financial forecast for 2006, which assumes normal streamflow conditions for hydroelectric generation, shows that Avista will again absorb a substantial portion of the $9 million deadband if the deadband is not eliminated. Thus, the power costs included in base retail rates right now are too low, and the Company again will not recover its power costs in 2006 because of the deadband.

Therefore, elimination of the deadband would serve a number of very important purposes. Elimination of the deadband would reduce the impact of setting the level of power costs in base retail rates at the wrong level. Without the deadband, 90% of the differences in the actual power costs and the power costs embedded in retail rates would be trued-up. This would ensure that

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million.

neither the Company nor the customer would be substantially harmed if the base power costs are not set at the right level, notwithstanding everyone's best efforts. In addition, with the continued volatility in wholesale electric and natural gas prices, and the uncertainty of hydroelectric conditions, elimination of the deadband would provide important additional financial stability for the Company as it refinances significant maturing debt, and funds its capital requirements in the next few years.

Q. What has been the Company's experience with the deadband since its inception?

A. Since the ERM was implemented in July 2002, the Company has absorbed $31.5 million of power costs through the deadband, and an additional $5.7 through application of the 90%/10% sharing, for a total of $37.2 million over a three and one-half year period. In addition, current projections show the Company will again absorb a substantial portion of the $9 million deadband in 2006. The $37.2 million itself, on an after-tax basis ($24 million), represents almost 75% of total annual earnings for Avista's Washington electric operations of $33 million.[3]

Q. Are there other considerations that the Commission should bear in mind as it considers elimination of the deadband?

A. Yes. With the persistent below-normal streamflow conditions that the region has experienced in recent years, we are due for an above-average year. If hydroelectric generation is above-average, it would provide additional energy that could either be sold or could be used to avoid power purchases or thermal generation – both of which would reduce overall power supply costs. Although we have a good start toward a normal or better runoff for 2006, it is too early to predict with any degree of accuracy what will occur in the months ahead.

[2] $791 million rate base x 40% equity x 10.4% return on equity equals $33 million.

Irrespective of whether hydroelectric conditions in 2006 are better or worse than normal, the elimination of the deadband now will be beneficial for both the Company and its customers in the long-term. If streamflow conditions are better than normal and costs are reduced, with elimination of the deadband 90% of every dollar of reduced power costs would benefit customers by further reducing the current deferral balance of $96 million. If hydroelectric conditions are below normal, elimination of the deadband would allow the Company to avoid yet another $9 million hit to its financial results.

In either case, elimination of the deadband would allow Avista to make meaningful progress in improving its access to capital under more favorable terms, which will be good for the Company and its customers.

Q. What is the Company's specific request in this filing related to the ERM and the deadband, and why is it in the public interest?

A. Avista is proposing that the existing ERM mechanism continue for an indefinite period of time, but without the deadband. The existing 90%/10% sharing feature, however, would remain. This would not preclude future review of the mechanism in a general rate case or other forum determined to be appropriate by the Commission.

Avista does not expect to regain an investment grade credit rating until at least 2007, and elimination of the deadband would provide additional financial stability to allow for an upgrade in 2007 or shortly thereafter. As mentioned earlier, the Company has important refinancings coming up in 2007 and 2008, as well as large capital investment requirements in the next several

[3] $791 million rate base x 40% equity x 10.4% return on equity equals $33 million.

years. A return to investment grade status in the near-term, therefore, takes on added significance.

In addition, it is our hope that the current Washington power cost deferral balance will be fully recovered by the end of 2008. The balance at December 31, 2005 was $96 million. The current ERM surcharge of 10.8% will collect from customers approximately $31 million per year. If the Company were to experience relatively "normal" power supply conditions for the next three years, the current deferral balance of $96 million would be near zero by the end of 2008. Avista has attempted to mitigate the rate impact on customers from the costs associated with the 2000/2001 energy crisis, and the persistent below-normal hydroelectric conditions in recent years, by spreading the recovery of these costs over a period of years. The delay in recovering these costs, however, has delayed the Company's ability to recover financially. It is important that we make meaningful progress between now and the end of 2008 to eliminate this balance so that the dollars can be used to buy down debt and/or finance capital requirements.

Finally, the Company, through the Settlement Agreement, made a commitment to build the utility equity component to 35% by December 2007 and to 38% by December 31, 2008. This commitment was made as part of a negotiated package that was based on a deadband of $3 million, a revenue increase of $22,135,000 and 1% rate reduction penalties for not meeting the equity targets. In its conditions to the Settlement, the Commission reduced the $22,135,000 revenue increase, reverted to the $9 million deadband, and doubled the rate reduction penalties for not meeting the equity targets. The elimination of the deadband will assist the Company in meeting these equity targets.

Elimination of the deadband will help insure further improvement to Avista's financial strength, which will provide long-term benefits to customers through improved access to financing under more reasonable terms. This improvement is consistent with the customers' interest, and is in the public interest.

Q. How does Avista's Power Cost Adjustment (PCA) mechanism for its electric operations in the State of Idaho compare with the ERM?

A. The PCA in Idaho for Avista's electric utility business is almost identical to the ERM in design, with the exception of the deadband. In the PCA, 90% of the changes in power supply costs on a monthly basis are deferred for later rebate or surcharge to customers.

Q. Would elimination of the ERM deadband eliminate the majority of the risks faced by Avista?

A. No. The utility faces many other risks and challenges apart from the variability of costs associated with hydroelectric generation and wholesale electric and natural gas prices. Avista's retail revenue can change substantially from changes in weather conditions and other factors affecting customer usage. New investment related to customer growth and equipment replacement is more expensive, in general, than the equipment installed many years ago, resulting in increased costs that are not recovered until a future rate case. Avista, and others in the industry, are continuing to experience increased legal costs, audit fees, insurance and other costs as part of the fallout related to the energy crisis of 2000/2001, the September 11, 2001 act of terrorism, and compliance with new accounting and reporting rules such as Sarbanes/Oxley.

Furthermore, base retail rates in Washington continue to be based on a historical test period; the use of forecasted information, future estimates, and attrition adjustments, that recognize

increases in certain costs over time, are not presently allowed. There is a constant challenge each year to manage costs within a revenue requirement that is based, in large part, on historic information that may not reflect future conditions.

Q. If the deadband were to be eliminated, would Avista continue to have an incentive to manage its power supply costs to the benefit of customers?

A. Yes. There would continue to be a 90%/10% sharing of all changes in power supply costs under the ERM. Therefore, to the extent the Company has control over certain cost items, it has the incentive to make the most economic choice for the Company and its customers.

In addition, the Commission Staff and interested parties perform audits of the Company's performance in managing of power supply costs as part of the annual ERM filings, in order to determine whether costs are prudent and suitable for recovery. Since the ERM's implementation in 2002, the Company has submitted monthly ERM reports, as well as a detailed annual filing, which are reviewed by Commission Staff and other interested parties. This oversight process is an additional incentive for the Company to make prudent choices as it manages its power supply costs.

Q. Are power supply and fuel cost tracking mechanisms common in other state jurisdictions?

A. Yes, power supply and fuel cost tracking mechanisms are very common in other state jurisdictions, especially in states that have not engaged in some form of retail access. In March 2005, Banc of America Securities (BOAS) published a report entitled "The Kaleidoscope of Power – Regulation in Focus." In that report, BOAS summarized the "Adjustment Clauses" that

are currently in place for the respective state jurisdictions. Excerpts from the report for some of the state jurisdictions are as follows:

Alabama	**Adjustment clauses are permitted (after a hearing) via quarterly adjustments, up or down, and are based on forecast costs with true-ups for past deviations from forecast.**
Arkansas	**Fuel and the energy component of purchased power costs are adjusted annually through the Energy Cost Recovery Rider based on a combination of historical and forecast information. Interim adjustments are permitted in the event of significant deviations from actual experience.**
California	**Annual review through the Energy Resource Recovery Account, with forecast costs early in the year and a prudence review in second half.**
Georgia	**Adjustment clauses are permitted, based on projected three-month fuel and energy-related purchased power costs and past over or under collections. The GA PSC must rule on the filing within 90 days of the filing or the change is deemed approved.**
Hawaii	**Hawaiian electric utilities have an energy cost adjustment clause that does not require prior HI PUC approval of changes once the initial clause is established. The HI PUC staff periodically audits the plan.**
Indiana	**Permitted by law. Recovers fuel and purchased power expenses. Not more than one filing for recovery every three months.**
Mississippi	**The fuel and the energy portion of purchased power costs, plus emissions allowance costs, are forecast for the next 12 months and then trued-up in the following 12-month period.**
Nevada	**Utilities have two options. They can file for an increase in fuel and purchase power costs as often as monthly, or they can use the deferral method and true-up costs annually, with any deferred amounts recovered over a period of up to three years. Both electric utilities currently use the latter method.**
North Dakota	**Fuel cost adjustments are permitted on a monthly basis.**

Oklahoma **Fuel and purchased power adjustment clauses are permitted, provided that the OCC reviews and approves the changes prior to their going into effect. Adjustment clause relies on actual fuel costs, not estimates.**

Washington **Fuel and purchased cost adjustments are permitted, and Puget and Avista have adjustment clauses in place. The current plans subject the utility to the risk/reward of under/over collection of a portion of the change in expected costs before costs are passed on to customers. This "dead band" approach has subjected the utility to greater earnings volatility than a simple recovery mechanism. (emphasis added)**

It is important to note that the Banc of America Securities report highlighted the increased exposure to Avista from the deadband, as compared to other tracking mechanisms. Furthermore, as indicated by the above quotes from the report, some of the tracking mechanisms allow the use of forecasted information, or monthly or quarterly price changes, which provides more timely recovery of costs, and a price signal to customers on the changes in costs.

Q. Would elimination of the deadband result in an inappropriate shift of risk from shareholders to customers?

A. No. As already noted above, the size of the deadband ($9 million) has subjected Avista to greater earnings volatility than other similar mechanisms. In addition to the exposure from the deadband, the Banc of America Securities report provides the following assessment at page 61 related to return on equity and the common equity ratio (page 61 is attached as Exhibit No. ____ (KON-2):

> Return on Equity – Average to slightly lower-than-average awarded returns on equity with capital structures that also reflect lower common equity relative to the capital structures adopted by other states, in our view. (emphasis added)

In this report, Washington is recognized as generally providing a lower ROE and a lower equity capital structure as compared to other states. Although Public Counsel and ICNU in the recent rate case expressed concerns regarding a shift of risk from the Company to customers with a reduction in the deadband, in reality it appears that Avista is already bearing more risk than other utilities. As Mr. Malquist explains in his testimony, this additional risk that is currently borne by shareholders (through the deadband and generally lower ROEs and capital structure), is one of the factors contributing to Avista's below-investment-grade credit rating of BB+ (S&P), which is among the lowest of all utilities in the country. This strongly suggests that greater financial support is warranted to strengthen the financial condition of the Company. Elimination of the deadband is one step in providing this support, and will be perceived as such by the investment community, as Ms. Cannell explains in her testimony.

Q. Is it instructive to consider how changes in natural gas costs are handled for natural gas retail distribution companies?

A. Yes. The WUTC has approved tracking mechanisms for natural gas distribution companies, including Avista, that provide for a dollar-for-dollar recovery of the changes in natural gas costs to serve its customers. Each month actual gas costs are compared with the gas costs collected from customers in retail rates, and the difference is deferred for later rebate or surcharge to customers. The dollar-for-dollar recovery of costs is due, in part, to recognition that the future market price of natural gas is not predictable and, other than through the implementation of hedging programs, is beyond the control of the utility.

In a similar manner, future natural gas prices for thermal generation and future streamflow for hydroelectric generation are unpredictable and beyond the utility's control. Although we

believe it would be reasonable and appropriate to track the changes in power supply costs on a dollar-for-dollar basis through the ERM, the Company is proposing elimination of the deadband, but not the elimination of the 90%/10% sharing at this time.

IV. OTHER ERM-RELATED ISSUES

Q. In its recent Order, the WUTC noted ERM-related issues, other than the deadband, that need further review. How has the Company responded to these issues in this filing?

A. One of the issues identified by the Commission's recent Order for further review is the determination of the appropriate rate to use in the calculation of the Retail Revenue Credit. Mr. McKenzie addresses this issue in his testimony. As I mentioned earlier, the Company is also proposing to add transmission revenue and expense components to the ERM, in response to recommendations previously made by Public Counsel. Mr. Johnson will explain these changes. Later in my testimony I will address the Production Property Adjustment that was the subject of much testimony in the recent case.

Q. Is there a need to make other changes to the ERM?

A. No. Although Mr. Lott's raised a number of issues in his testimony in Docket No. UE-050482, he did not demonstrate that any part of the ERM is wrong or improper. The issues or concerns raised by Mr. Lott, on behalf of Public Counsel, were not driven by legitimate deficiencies or problems with the ERM, but by preferences by Mr. Lott as to how he would design a mechanism.

The ERM is well designed and is comprehensive in capturing the power supply related revenues and expenses that it was designed to address. The design of the ERM was developed and adopted as part of a Settlement Agreement that was signed and supported by all parties in Docket No. UE-011595, including Staff, Public Counsel, and ICNU.

Avista makes a filing every year to provide the Commission Staff and other interested parties the opportunity to review the costs under the ERM. The costs under the ERM have been reviewed three times in the past three years, including participation by Public Counsel and ICNU, and the process has worked as intended.

Furthermore, the PCA in Idaho has been in place for over 16 years. It has been refined and improved over those years. The existing ERM is essentially identical to the current PCA in Idaho, with the exception of the deadband. The design of the ERM and the PCA, therefore, has been refined over time and has a proven track record.

Q. In his testimony in Docket No. UE-050482 on behalf of Public Counsel, Mr. Lott made reference to a "properly designed PCA." Do you have any comments related to this reference?

A. Yes. Mr. Lott seems to imply that there is only one way to design an effective power cost tracking mechanism. It obviously makes no difference what the mechanism is called, whether it be called an Energy Recovery Mechanism (ERM), a Power Cost Adjustment (PCA) mechanism, an Energy Cost Adjustment Clause (ECAC), or some other name. The most important consideration is that it is effective and fair to the Company and its customers in how it treats the revenues and expenses that it was designed to address.

With regard to Mr. Lott's reference to a "properly designed PCA," it is not credible to suggest that there is only one design or one methodology for a power cost tracking mechanism for all utilities and for all circumstances. The existing ERM mechanism is based on actual costs with few adjustments, and, as such, is very straightforward. These actual costs are then subject to a review in the annual ERM filing to ensure that they are prudently incurred, prior to the opportunity for recovery from customers.

Q. In his testimony in Docket No. UE-050482, Mr. Lott suggested there are some cost items in the ERM that should be addressed in a general rate case. Do you agree?

A. No. Mr. Lott expressed concern regarding the inclusion of new power contracts in the ERM. It is reasonable and appropriate that the revenues and expenses from new power contracts be included in the ERM for a number of reasons. In designing the ERM it was recognized that the addition or termination of a power contract would affect other power supply cost items, and in order to capture all cost changes (up and down) on an "apples to apples" basis, it is necessary to include the new contract. Excluding the revenues and expenses from new power contracts from the ERM would require additional adjustments and, in some cases, assumptions to be made about what the revenues and expenses would have been absent the new contract. This would further complicate the mechanism, and move further away from measuring the actual changes in power supply revenues and expenses.

Under the ERM, Avista identifies any new contract in its monthly ERM report to the Commission, and provides a copy of the new agreement. In addition, as noted earlier, Avista makes a filing with the WUTC on or before April 1st of each year to provide the opportunity for interested parties to review the prudence of power costs during the prior calendar year. The

review period runs for 90 days, and can be extended by agreement of the parties or by order of the Commission. Therefore, the costs of any new contracts are subject to review prior to being approved for ultimate recovery from customers.

Q. In Docket No. UE-050482 Mr. Lott made reference to certain policy goals and guidelines identified by the Commission in 1989. Do you have any comments on these policy goals and guidelines?

A. Yes. These policy goals and guidelines from 1989 were established at a time when wholesale electric prices were approximately $22/MWh and natural gas prices were around $2.00/MMBTU. By comparison, current wholesale electric prices are roughly $60/MWh and natural gas prices are around $9.00/MMBTU. These higher wholesale prices have created a much higher variation in costs for utilities such as Avista that have a substantial amount of hydroelectric and natural gas-fired generation to serve its customers.

It is reasonable to expect conditions in the utility industry to change over time, and for it to be necessary to revisit guidelines that may have been established years ago. Conditions and circumstances have clearly changed since the prior guidelines were adopted over 15 years ago, and it is also clear that the Commission is not bound to continue to use guidelines that may no longer be relevant or applicable in today's environment. Although a review of these prior guidelines can be informative and instructive, the unique circumstances that are present today should guide decisions today.

V. PRODUCTION PROPERTY ADJUSTMENT

Q. In its recent Order in Docket No. UE-050482, the Commission also indicated a possible need to further address the "production property adjustment" issue raised by Mr. Lott. Is it appropriate to add such an adjustment?

A. No. The costs that Mr. Lott was intending to address with his Production Property Adjustment are already being accounted for in the existing ERM calculations. On Page 36, Paragraph 82, of its Order in Docket No. UE-050482, the Commission stated that:

> Mr. Lott testified for Public Counsel that without this adjustment Avista's fixed costs associated with production plant will be overstated on a unit basis. (emphasis added)

I have underscored the reference to "fixed costs associated with production plant" in the above statement, because those are the costs that are at the heart of this issue. Some power cost tracking mechanisms have adjustments built in for changes in retail load over time that address only the variable costs or non-plant related costs. With that type of design, an argument could be made that a separate adjustment related to the "fixed costs associated with production plant" should be considered.

The Retail Revenue Credit adjustment for retail load in the ERM, however, includes not only the "non-plant" related costs, but also the fixed costs associated with production plant. Therefore, the ERM already includes an adjustment for the costs that would be addressed in the Production Property Adjustment suggested by Mr. Lott. As Avista explained in the prior case, adding the Production Property Adjustment would adjust for these costs a second time.

Q. Why is there a need for an adjustment for changes in retail load in the first place?

A. In the recent Avista general rate case the retail load used to set retail rates is based on the actual 2004 (test year) kilowatt-hour (KWH) sales, with some adjustments. The actual sales for the calendar year 2004 are adjusted to reflect normal temperature conditions, and also to reflect any known changes to the number of customers or to their usage, such as new sales to a new industrial customer.

The Company's power supply costs included in the rate case are the total power supply costs to serve the 2004 retail load. These power supply costs include both the fixed costs associated with production plant, as well as all variable costs to serve the load. In theory, as retail loads grow, i.e., from 2004 to 2006, without an adjustment the Company would over-recover the fixed costs because the fixed costs are already being recovered by the lower 2004 loads. In order to ensure that these fixed costs are not collected twice as loads grow, an adjustment is necessary.

Q. How is an adjustment for these fixed costs already included in the existing ERM calculations?

A. As retail loads grow from the level included in the last rate case (2004 loads), the Retail Revenue Credit adjustment in the ERM makes an adjustment for this load growth. For example, if actual retail loads in January 2006 are 10 average megawatts higher than the January 2004 retail loads included in the last rate case, an adjustment would be made to reduce power supply costs. The adjustment would be equal to 7,440,000 KWH (10 aMW x 744 hours in the

month x 1000) times the Retail Revenue Credit rate of $0.03289 per KWH. Therefore, in this instance, power supply costs in the ERM would be reduced by $244,702.

The application of this Retail Revenue Adjustment in the ERM is consistent with the theory explained above, i.e., as retail load grows an adjustment is necessary to ensure that the fixed costs associated with production plant are not recovered twice. In this example, the power supply costs recovered through the ERM are reduced by $244,702, which accounts for every KWH of load growth. This adjustment for retail load occurs every month in the ERM calculations.

Q. How do we know that an adjustment for the "fixed costs associated with production plant" is included in the rate used in the Retail Revenue Adjustment?

A. The cost of production rate of $0.03289 used in the Retail Revenue Credit calculation is based on the total production costs in the cost of service study used to established base retail rates in the first place.[4] These costs include all of the "fixed costs associated with production plant," including depreciation expense and the return on production rate base. Therefore, to the extent that retail loads grow over time, the additional fixed costs collected by Avista will be credited back to customers through the ERM so that there will be no over-recovery of these costs.

In summary, it would not be appropriate to adopt a Production Property Adjustment, as Mr. Lott suggested in Avista's recent general rate case. The costs that Mr. Lott was intending to address with his Production Property Adjustment are already being accounted for in the existing

[4] Avista witness Ron McKenzie provides testimony related to the cost of production used in the Retail Revenue Credit calculation.

ERM calculations. Adoption of a Production Property Adjustment would adjust for these costs a second time.

Q. Mr. Lott previously argued that a Production Property Adjustment has been used for many years in Puget Sound Energy (PSE) rate cases. Does that suggest that a similar adjustment should be used for Avista?

A. No. As I explained above, the costs that Mr. Lott was concerned about with his Production Property Adjustment are already addressed by the Retail Revenue Credit that has been in place since the ERM was adopted in July 2002.

With regard to PSE, the need for a Production Property Adjustment related to load growth would be dependent on whether there was a power cost tracking mechanism in place at the time, and whether the design of the mechanism already had an adjustment built in for load growth.

The fact that some form of Production Property Adjustment has been used in the past for PSE, does not in and of itself, mean that the same adjustment is appropriate here. A careful review of the ERM and the Retail Revenue Credit clearly shows that an adjustment is already in place for retail load growth, and the Production Property Adjustment previously proposed by Mr. Lott should not be adopted.

Q. Does this conclude your prefiled direct testimony?

A. Yes.