BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. AVISTA CORPORATION Respondent.	) DOCKET NO. UE-991606
THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. AVISTA CORPORATION, Respondent.	) DOCKET NO. UG-991607) VOLUME XIII) Pages 1647 - 1759

A hearing in the above matter was held on July 12, 2000 at 1:30 p.m., at 1300 South Evergreen Park Drive Southwest, Olympia, Washington, before Administrative Law Judge MARJORIE R. SCHAER, Chairwoman MARILYN SHOWALTER, Commissioners RICHARD HEMSTAD and WILLIAM R. GILLIS.

The parties were present as follows:

THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, by MARY M. TENNYSON and GREGORY J. TRAUTMAN, Assistant Attorneys General, 1400 South Evergreen Park Drive Southwest, Post Office Box 40128, Olympia, Washington 98504.

AVISTA CORPORATION, by DAVID J. MEYER, General Counsel, East 1411 Mission, Spokane, Washington 99202.

THE PUBLIC, by SIMON J. FFITCH, Assistant Attorney General, 900 Fourth Avenue, Suite 2000, Seattle, Washington 98164-1012.

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES, by S. BRADLEY VAN CLEVE, Attorney at Law, Duncan, Weinberg, Genzer, Pembroke, 1300 Southwest Fifth Avenue, Suite 2915, Portland, Oregon 97201.

Kathryn T. Wilson, CCR

Court Reporter

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P R O C E E D I N G S

JUDGE SCHAER: Let's be on the record. We are here this afternoon for a hearing in Docket Numbers UE-991606 and 991607, for the general rate increase requests by the Avista Corporation in both its gas and electric operations. We are in the Commission's Hearing Room 206 in Commission headquarters, and it appears to me looking out at the counsel table that appearances today are the same as they were yesterday but for the fact that Mr. Van Cleve is not with us in the hearing room today. The point that we broke yesterday was we were having questions from the Bench to Mr. Norwood, and I believe you had another question?

CROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. I can't overcome my fascination with water years. At one point at the end of the day, you were concerned about asymmetry between high water years and low water years, and I think your point was that a high water year has less value to you than the negative value that a low water year has.

A. That has been the experience in the past, yes.

Q. Visually, I would think if instead of water years, we are talking about fiscal or financial water years or dollar water years, each year above the line would have a relatively lower, smaller magnitude, and the years below the line would have a larger magnitude; is that correct?

A. In terms of dollars, yes.

Q. So wouldn't that have the effect, if we were looking at a graph of dollar water years, of the mean dropping? In other words, because the low water years have a greater magnitude financially than above water years, if you are looking at financial mean, not water mean, wouldn't it be lower? Lower on the graph is all I mean.

A. I think I understand your question. The issue really is what we are looking for is an average of water conditions that we expect to occur over time, and it is true or has been true that if you have good water years, there is less value there than the bad water years, but obviously, what we're looking for is over time, we want those to average out, and if it costs us more in the bad water years, we need to reflect that in the rate-making process, but in order to do that, that's really independent of what series of water years you use. Once you pick a series of water years that represents average conditions, then you need

to recognize that there will be or can be greater cost during the bad years than during the good years.
Q. Let's just take a set of 40 years that was perfectly balanced in terms of water years above and below the line. They were equally above and equally below. I think what you were saying is that the low years cost more than the high years to you, so that actually that asymmetry, if you will, is built into your calculation of costs of water years.
A. Yes. And the asymmetry does need to be factored in because if you don't build in that asymmetry, then the Company will not recover its costs.
Q. Right, but is the asymmetry already built into it? In essence, when you said if you drop off two high years and you drop off two low years, those aren't equal because low years cost more than high years benefit, but if all costs over all those years already account for that fact, I was wondering if, in effect, it's not as asymmetric as you were proposing. That's my question.
A. I guess when you are looking at just the stream flow conditions, I guess I would have to agree that that would have to work to pull out the stream flow conditions, and once you've pulled out the highs and lows, as you were talking about yesterday, then you

would want to take a look at is what you have left still a representative number of average conditions, and again, it goes back to you would have to still pick a series of water years to choose before you throw out the highs and the lows, and then you are back to the same issue of what period do you use. Do you use 60 or 50 or some other period? Once you choose that, you should throw out some highs and lows, but you still want to take a look at is what you are using then actually reasonable and the best estimate of average conditions for rate-making purposes.

Q. I'm not sure what the implications of this line of questioning is. I think I wanted to make the distinction that if we are dealing with really fiscal water years instead of water years, there may be a different relationship between the high and low years than just the water relationship.

A. I think we have to recognize that if you just had like two water years is all we had to work with, one was bad and one was good, and from a megawatt perspective, the good one was 40 megawatts better and the bad one was 40 megawatts worse. From a megawatt perspective, you are equal. The positive would offset the negative, but from a dollar standpoint, if the good one gave you two million and the bad one cost you four

million, then you would need to reflect the fact that you need to collect an extra two million dollars because the bad are worse than what the good are good.
     Q.   But then let's say that you have ten years, and five are above and five are below, and the ones below cost you twice as much as the ones above. My question is, when you look at that whole ten years, are you assuming that you divided it all in half, or are we taking account of the fact that the low ones cost twice as much as the high ones already when we look at what it costs over time, or what the hydro system over time means financially. Did we already take the two-to-one in account, or are we assuming that the average water year is right down the middle so it's the middle?
     A.   We need to use the average stream flow condition and megawatt condition, and we need to recognize that the bad years cost more than what the good are good. If we don't recognize that symmetry -- I'm trying to think of a better way to explain this -- then you are not going to recover all your costs, and I guess I'm thinking of it this way: If the good years are as good as the bad years are bad from a dollar perspective, then you would want to use megawatts above and below that are equal.
           If where you are leading is do you want to

have more megawatts that are good than bad megawatts, if we operated under that condition, then the Company wouldn't recover all its costs because it's assuming you are going to have more good water conditions than bad water conditions, and that's the random variable that we really can't say is true. We don't want to include more good water years than the average than bad water years to offset the costs because we can't count on more good water years happening than bad water years.

Q. I'm not leading anywhere, to tell you the truth. I wanted to explore that relationship, and after just raising it with you, people can go back and think about it. What I'm wondering is if that difference has already been accounted for in our modeling?

A. It has been.

Q. Then it may not be true that if you lop off two symmetrical years, you've got asymmetry.

A. I believe I think your statement is true, which I would have to retract what I said yesterday about the asymmetry problem on that part of it.

Q. Yes.

A. I think you are right, so I will back up on that one, but you still have to go back and look at

what period of water years do you use before you do the lopping off.
Q. Yes. I don't mean to be proposing seriously the lopping off. It's an idea, but it just demonstrates this issue.
A. I think you are correct.
CHAIRWOMAN SHOWALTER: Thanks.
JUDGE SCHAER: Anything else from the Commissioners?

CROSS-EXAMINATION

BY COMMISSIONER GILLIS:
Q. You had indicated that the nonrandom variance is accounted for by the model already. Do you remember having that conversation?
A. Yes.
Q. Explain to me a little more how that is accounted for in the model?
A. What we used in this case for the nonrandom variables are the existing hydroplants that are in place today -- Noxon, Cabinet, Spokane River plants -- and then the rights, the power we have from the Columbia Project, so we know that today. And then you have operating conditions for those plants, release of water from the reservoirs, heavy load, light load,

release of water and that sort of thing. All of that is factored into the model that is used to determine the amount of output for hydrogeneration that's included in the dispatch model.

The numbers that we get from Northwest power pool then include the amount of hydrogeneration based on historical stream flow conditions but with today's plants in place and operating conditions. Those are the nonrandom. Then what we do for the 60-year study is we take the 1928 stream flow conditions and we run them through today's hydroplants and operating conditions. We take 1929. We do this every year for 60 years, and then we take the average of those 60 years to reflect the average power costs, the average hydrogeneration and the average power costs for rate-making purposes.

So the nonrandom are built into the model in what power plants are here and how they are operated. The random is the historical period of stream flows that if they reoccurred, what kind of power output would you get.

Q. And for the nonrandom variables, examples you just listed, how do you make them forward-looking? Is the assumption that current operation of the river, for example, the way the river is going to be operated for the next 10 years, or how are you looking at this?

A. All we can do is reflect the current, what we know today, about the operation of the rivers and the existing power plants, and that may change next year. It may change several years from now, but we don't know that. All we can reflect today for rate-making purposes is what we do know, which is what's known and measurable, and the bottom line here is we are looking for the average output for the hydro projects for rate-making purposes for the next year or next several years. All we can use is what's known and measurable, and we know that at some point in the future, things may change, and when they do, we will have to reflect that.

The concern on how to deal with the rolling methodology is that it doesn't use the best estimate of average conditions for the next year or several years. It uses a less reliable estimate and counts on some future offset to occur. In the example of the Columbia Projects, if that hydrogeneration goes away for us, there is no opportunity for that offset to occur in the future, and that's the issue.

Q. I understand that. The other question I had for you is that you had answered that it may be useful to reevaluate the dispatch modeling in light of the changing circumstances, and we discussed the fact that there appears in recent times to be less of a link between water flows and costs. Why wasn't that done for this proceeding?

A. We are in the process now of developing an hourly model, and Mr. Buckley talked about it in his testimony, and we've provided a copy of the draft version to him. We visited with him about that, and we are in the process of finishing up that hourly model, which will take into account the hourly output, hourly operation of our system.

That still though will not resolve the whole issue of are market prices correlated to hydro conditions, because even in operating your system on an hourly basis, you still have to input what you think the prices are during the heavy-load hours, light-load hours for each month. I'm not aware of any really good models out there to predict what kind of market prices we are going to see to the future. In the past, there has been this pretty decent correlation. If water years are bad, you end up with higher prices. In good water years, you have lower prices, but I think there has been a change there.

Q. You enter a discussion of the value of a PCA because of this, and is revamping of the model to reflect changing circumstances something that is a realistic alternative to approaching the problem.

Revamping the model is not going to help a lot on the unpredictability of market prices. It will help with the hourly operation of the system, and in recent years, there have been some changes in our system as far as the heavy-load operation, light-load operation. It's become much more important, and as the market prices get higher, it's going to be more important to take a look at what hours of the day are you buying and selling and what hours of the day, what is it costing you during those hours, so the model will help in that perspective, but as far as predicting prices, it's not going to help a lot in that arena, and that points to the need of PCA's as you mentioned?

COMMISSIONER GILLIS: Thank you.

JUDGE SCHAER: Anything further from the Commissioners?

CROSS-EXAMINATION

BY JUDGE SCHAER:

Q. Yesterday during your testimony, Mr. Norwood, you made reference to some Winterfeld testimony, did you not?

A. Yes, I did.

Q. I think you were even holding onto a document and waving it at us and saying, "This is what Mr. Winterfeld had to say. Was that a piece of evidence that was before this Commission in another proceeding?

A. Yes, it was.

Q. Can you tell me what docket that was in?

A. That was in Cause Number U-8536, and this document is labeled as Exhibit T-74.

Q. Is Docket U-8536 the last time the Washington Water Power Company had a fully litigated power supply case before the Commission?

A. There is a visit of the power supply issues in 1990, but as far as litigation, I believe it was the 8536 case, yes.

Q. I started worrying yesterday that Staff has been referring to Mr. Winterfeld's past testimony and what it establishes and how it's reflected in orders, and the Company has been doing the same thing, and I'm kind of addressing this more to counsel than to Mr. Norwood, but I think it might be appropriate for us to get something in this record that is Mr. Winterfeld's past testimony so we know what it is that's being referred to and relied upon by Mr. Norwood and Mr. Buckley. I'm wondering about having you produce the exhibit that you were referring to and relying upon in your testimony yesterday. I'd like to hear the thoughts of counsel on that.

COMMISSIONER HEMSTAD: Rely upon or disagree with.

MR. TRAUTMAN: Your Honor, I believe Staff only referred to the order of the Commission.

MS. TENNYSON: Your Honor, if I might elaborate, I had proposed to use the order in that case as a cross-examination exhibit with Mr. Eliassen but not admit it into the record. We could admit it into the record. There is a place holder in the exhibit list for that.

JUDGE SCHAER: So you are talking about the order from U-8536?

MS. TENNYSON: Yes.

MR. MEYER: I don't have an objection to the order, but I do have an objection to introducing testimony out of that docket as an exhibit. I think anybody is free to ask about what Mr. Winterfeld may have said or their views with regard to that, but then it puts the Company in the difficult position of essentially having to cross-examine some witness, and I don't know who that witness would be, about Mr. Winterfeld's testimony when he is not here, so I would object to that.

JUDGE SCHAER: My concern is that Mr. Norwood is here as an expert witness, and he has given his opinion about what Mr. Winterfeld testified to, what studies Mr. Winterfeld relied upon. I think it's appropriate to allow him to give his opinion, but my understanding then of the evidence rules is that anyone can examine on what the basis for that is, and since the basis of much of what he said yesterday appears to be this Winterfeld testimony, I think it might be useful to the trier of fact to know what it is that he's referring to.

I'm not really indicating that this would be substantive evidence so much -- I've looked at the orders, and the orders don't say a lot, to my mind. They don't say nearly what Mr. Norwood was saying yesterday, so I have a problem here, and I went through kind of a notebook about old orders today, and I looked up first U-8428, and it appears that you, Mr. Meyer, were involved in that proceeding for the Company, and it appears in that order at Page 14 that the Company and Staff had proposed use of a 40-year water study that Public Counsel had criticized that saying that the 40 years being used then took in too much of an earlier period where there was a lot of low water and that the

Company and Staff won and got 40 years, and I believe that was referred to yesterday in the testimony. I then looked at U-8533. Actually, excuse me, it was U-8536. What were you referring to in that docket, Mr. Norwood?

THE WITNESS: Are you asking what I referred to in that order?

Q. (By Judge Schaer) Yes.

A. You may have to let me know what statement I may have pulled out of that order.

Q. I just asked you what case you were using testimony of Mr. Winterfeld from, and you said that the document that you were referring to in your testimony yesterday was from U-8536; is that correct?

A. Yes. And your last question was?

Q. My last question was what were the positions of Commission staff and the Company in that proceeding about power supply and water normalization?

A. On Page 17 of that Third Supplemental Order, it says, "Commission staff contended that the Company's method was more reliable predicting perspective average water conditions but was not the best method for enhancing long-term accuracy while reducing year-to-year variation." That's on Page 17 of that Third Supplemental Order, and on Page 18, I made a reference to that. It says, "The Commission's decision does not mean that the Commission will use a rolling 40 years for all future cases. The Commission will evaluate alternatives proposed in future cases."

Q. What were you referring to yesterday in Mr. Winterfeld's testimony in that proceeding?

A. That was in his testimony on Page 5, I think, is what I referred to, on Line 10. It says, "A rolling average of a more current stream flow conditions will produce a less reliable estimate of average conditions but will generally reduce the cumulative error in normalizing long-term revenues and production expenses."

JUDGE SCHAER: I'm going to make a Bench request at this point for a copy of that testimony to be provided to the Bench.

MR. MEYER: May I inquire, is it clear that in response to that Bench request that the response will not go into the record in this case?

JUDGE SCHAER: That has not yet been determined, Mr. Meyer.

MR. MEYER: But at some point, my objection needs to be ruled on. It is a fairly important point --

JUDGE SCHAER: At this point, I want the

material provided, and then if I decide I would like it in the record at some point in this hearing, we can discuss your objection, but at this point, I would like the material provided. How quickly can that be done?

MR. MEYER: Mr. Norwood?

THE WITNESS: I have a copy here. We could have that made today.

JUDGE SCHAER: That will be Beverage Request No. 3, please.

MR. TRAUTMAN: Your Honor, is it the Bench's intent to relitigate that issue? Staff did not relitigate the issue in that hearing, and I would point out that Mr. Norwood did not provide any new evidence either until June in the rebuttal. Now, Staff has referred to the Commission's order, and that is a matter of record. So I guess Staff needs clarification. Are we now expected to relitigate that issue?

JUDGE SCHAER: I don't think any of that has been determined at this point. At this point, there has been a Bench request, an item that this expert witness relied on in his testimony yesterday to be copied and provided to the Bench.

MR. FFITCH: On behalf of Public Counsel, I would like to echo the concerns of Staff. I think there is a number of difficulties with this direction. First of all, Mr. Norwood did not, in fact, support his expert opinion, lately provided only rebuttal with reference to this testimony in his file to testimony, be he has not himself chosen to offer this evidence in support of his testimony.

Secondly, if the Bench is going to go back to the '84 case and look at one party's evidence, I would request that Public Counsel's evidence in this case also be provided to the Bench.

JUDGE SCHAER: Then we can make that Bench Request No. 4 that you provide your testimony, Mr. ffitch.

MR. MEYER: I think this is getting out of hand.

CHAIRWOMAN SHOWALTER: Let's have discussion about this and go off the record.

(Discussion off the record.)

JUDGE SCHAER: While we are off the record, there was a discussion among the Commissioners and the Bench about how to deal with the present state of information on power supply and water normalization, and I believe Commissioners are going to recap some of that discussion and some of the concerns for you at this point.

CHAIRWOMAN SHOWALTER: I think the decision was to withdraw the Bench request and not ask for evidence in the old proceeding. However, the issue of the water years is obviously of interest to the Commission, and we are interested in making a good decision about it. The dilemma is that the Company did not raise this issue in the case in chief and only raised it in rebuttal. That means that the Staff has not had an opportunity to rebut, so as we see it, there are different alternatives here. If the Staff is willing to concede the point, the Company's point that it has made in rebuttal, it could indicate that, and I don't mean you have to indicate it any time soon. Why don't you think about this. If you don't concede the point and would like an opportunity to present some rebuttal, we would need a period of time for surrebuttal. That would mean that the Company would need to extend the time period. I don't know how long that would take. You would have to think about that, and you would have to think about extending the time period, but it is the Company that has put us in this position.

What we are reluctant to do is say, "Well, you didn't raise it in your case in chief. You only raised it in rebuttal so forget it," because these are of real interest to us. Why don't I let Commissioners Hemstad and Gillis add anything before taking comments. So the long and short of it was to try to express to you our struggle here, and you might take some time overnight to think about how best to address it.

COMMISSIONER HEMSTAD: The Chair has really stated the dilemma and the choices, but first, it seems to me our order in the '92 Puget case was very clear, that they are going forward, and Water Power was a party to that proceeding, that there would have to be clear and convincing evidence in order to change from the decision made of using the 40-year rolling methodology.

Mr. Norwood has now made that effort. Staff in its case simply relied on the '92 order saying that that's what the Commission had decided and that there was no clear and convincing reason to change that. We think at least the prima facie case has been made to make that change but it's coming awfully late, so again, in order for us to be able to make the correct decision, if that's the way to put it, it seems Staff and Public Counsel have to have the opportunity to be able to make a case on this issue, if they want to, but we are also running out of time to make a decision here.

If the Staff and Public Counsel or -- ICNU is not here today -- wanted to put in evidence essentially reaffirming the Winterfeld methodology or at least the consequence of that, they have to have the opportunity to do that. If Staff and Public Counsel, ICNU want to pursue it, and the Company won't extend the period of time, then it would be my view that the rebuttal testimony on this issue should be stricken, which would leave the record in such a way that we would most likely readopt the 40-year rolling average.

COMMISSIONER GILLIS: I don't have much to add it to than to note the importance of this particular issue and decision and that the money consequence of it is something we take very seriously, and we need the best record possible to make that decision. The options have been laid out and the consequences.

COMMISSIONER HEMSTAD: It would seem appropriate for the parties to have an opportunity to discuss this among themselves as to how they wish to proceed and advise us tomorrow morning as to what are your elections and options here.

CHAIRWOMAN SHOWALTER: I think you probably wanted to make some kind of comment right now?

MR. MEYER: Yes, please. I certainly

understand the desire of the Commission and the fact of all parties to have a record that is a good record in this case. That having been said, I think that if I could be allowed a question or two of Mr. Norwood that I think goes to the very premise of really what underlies your concerns about what information was provided to Staff and Intervenors before they filed their direct case in this proceeding, it might allay some of your concerns. May I just have a question or two with this witness?

JUDGE SCHAER: Are you discussing what was in the Company's case before they filed or are you discussing something else?

MR. MEYER: I was discussing with this witness what information on this very issue had been finished to Staff and Intervenors, either in the Company case in chief, the direct case, or in response to data requests prior to the time that Staff and Intervenors filed their case.

CHAIRWOMAN SHOWALTER: I think it's probably better that you have your discussion overnight about all this and then come back to us, because which option we pick is not going to get resolved today. If after hashing this over it's still relevant to do something like that, that's okay.

MR. MEYER: Fair enough.

COMMISSIONER HEMSTAD: If you have any comments on the concerns that we have raised, I'd like to hear it.

MR. TRAUTMAN: I think Staff needs to discuss the various options. I think Staff is concerned at this late date, even with surrebuttal, if we are essentially asked to relitigate this issue that's been only raised by the Company about one month ago. We'll need to discuss our options.

COMMISSIONER HEMSTAD: Then you also should think about then if that is going to be your position, what motions you are making here, taking that into account, and also you might think about how we will rule on those motions.

MR. MEYER: Just for the record, if I may, I want it very clear on the record that there was sufficient information provided in our direct case, if one examines just the direct case, to show that arguments were presented in a different way, a more compelling way for the other parties in this case to have responded in their cases in chief, so our direct case had clear and convincing evidence, in our view, the use of the longer period.

CHAIRWOMAN SHOWALTER: Maybe in this case I think our statements up here were that you mainly put this in the rebuttal, and if that's not the case, I think it would be helpful if you point out to us, not this minute, but tomorrow, where you did mount this evidence initially, and then it would also be relevant what sorts of information you gave in the meantime.

COMMISSIONER HEMSTAD: I would make the comment that Mr. Norwood's rebuttal testimony is quite elaborate and detailed in addressing this question.

MR. FFITCH: Your Honor, Public Counsel would make a couple of comments, if I may, at this point. First of all, we would take issue with Mr. Meyer's characterization of the direct case and the discovery in that time frame and concur that while the issue might have been identified in some fashion in the direct round that the effort to make a case for a change really did not occur with any degree of specificity until the rebuttal case.

Secondly, I would just like to underline that comment that Commissioner Hemstad made. The Commission resolved this issue after almost a decade of litigation in the '92 Puget to which Washington Water Power was a party and Mr. Norwood was a witness, and I think there is a pretty high threshold of reopening this question at this time. We would be happy to think about the

proper approach that we would recommend overnight.
MR. TRAUTMAN: Staff concurs with all of those comments. We take great exception to the contention that the Company presented the new evidence, the clear and convincing evidence that the Commission has required in its direct case. We firmly believe that even allegations were not made until the rebuttal case.
CHAIRWOMAN SHOWALTER: I just want the parties to distinguish both the procedural issues here from the substantive ones. The procedural way this issue has come about is problematic, but I don't think that should necessarily resolve the whole issue; that is, we are focused as well on the substance, and as the old order says, the Commission did not put this to bed forever. It put it to bed until better evidence comes along, unless and until, so I don't personally think that it substantively resolves issues to say, "Well, that's what the Commission said then. You didn't do this right." That may, but it doesn't resolve it substantively. I think there is a real issue here.
JUDGE SCHAER: I think at this point if there are any questions that the parties wish to ask in order to be able to prepare for discussions among yourselves or your presentation tomorrow morning, it might be

appropriate to ask those briefly, but otherwise, I think any further statements should be made tomorrow morning when we take up this matter again. Are there any questions at this point?
CHAIRWOMAN SHOWALTER: I have one more administrative matter since we are talking a break. Yesterday, Mr. Parvin, I think it was, distributed RCW 35.21.860 that was about the franchise fees, and I thought at that time that this might have been the subject of legislative amendment, and I checked and, in fact, it was, and I'm not sure if it makes a difference to these particular arguments, but I think everyone should be dealing with the current law, Chapter 83, Section 8 of laws of 2000. It was ESSP 676, and my assistants made me copies, so if you want to check it over to see if it makes any difference at all, I have those.
JUDGE SCHAER: That brings us back to questions for you, Mr. Norwood.
Q. (By Judge Schaer) This is a general question about consistency in treating power costs to be included in normalized expenses. Looking at your Exhibit T-203 at Page 54, Line 4, you recommend there that the actual Centralia power replacement contract costs be used for setting rates and that this replace

the cost of Centralia that would otherwise be included in the 1998 test year; is that correct?
A. Yes.
Q. On the other hand, looking at your Exhibit T-203 at Page 7, Line 1, you propose that the level of PGE contract revenues that were in effect during the test year should be held constant, even though they have changed because of the restructuring of PGE contract; is that correct?
A. Yes, and I explained in my rebuttal testimony the circumstances surrounding that monetization transaction and the reasons why it's appropriate to continue to include that levelized amount for rate-making purposes.
Q. Why don't you give me a brief summarization again of how you square these two apparently inconsistent approaches to establishing an appropriate level for test year power expenses.
A. For the PGE monetization transaction, that transaction was to -- it was really a financial arrangement to monetize not all the agreement but part of the agreement from 1999 through 2014. We didn't change 2015 or 2016. We had concerns because of what was going on in the State of Oregon, that PGE had recently been merged with another company. There was

restructuring going on, and because of a provision in the contract, we had concerns about the revenues from that contract being received by the Company, so we entered into this arrangement to lock that value in, and PGE didn't buy the agreement out. They continued to pay $10 per kilowatt month, and we continued to provide the 150 megawatts of capacity each year over the same term, but what we did do is receive that money up front in order to lock that value in, and the intention was to preserve that value, and we are continuing to flow that value through to customers in this proceeding under the same revenue stream that we had in the beginning, and that's the rate-making methodology that we had proposed a year and a half ago when we put the agreement together and when we filed the agreement with FERC.

Q. Then specifically concerning the PGE contract restructure, why did the Company choose not to directly inform Commission staff of the changes made to the PGE contract?

A. I'm not sure. I wasn't involved in it in the last six months so I'm not sure why we didn't choose to do that. I know there was no requirement to do it. I think historically in the past we tend to notify the Commission of these things. I'm not sure why there

wasn't a formal notification on that one.
          I think I mentioned yesterday there was a Commission basis report that we file every six months, and that adjustment was included in that Commission basis report that we filed in November of that last year. As far as a formal notification, we didn't provide a notification.
     Q.   What justification did the Company make to establish a deferral account in which to amortize the PGE contract structure cash proceeds without requesting approval for accounting treatment from the Commission?
     A.   It's my understanding in talking with our accountants that there wasn't a requirement to get an accounting order in order to defer those revenues and to amortize that over to the period of the arrangement.
     Q.   Looking further in your testimony, you rebut recommendations by Mr. Buckley on use of a 40-year rolling water record in the dispatch model. That's not where my question lies. It's the next point here. You also have disputed Mr. Buckley's recommendation to use the proceeds from the PGE contract restructure to offset various components of revenue requirement and to buy down rate base; is that correct?
     A.   Yes.
     Q.   Is the Company proposing that if the

Commission favors the offset approach rather than the deferral approach, it would accept the Staff offsets so long as, one, the deferral balance is adjusted to October 1st, 2000; two, the ice storm and Nez Perce items are included, and three, the rate base offset is reduced to 14-and-a-quarter years.

A. No. We don't view that as a proposal by the Company one that is desirable, and one of the major reasons is the -- one example is the buyout of a contract. The proposal to do that is to buy out a very inexpensive financing arrangement, which the rate is about five-and-a-quarter percent on an after-tax basis. If we were to have to buy that out at our current cost of money, it would be more in the range of 8.8 percent, and if you compare the existing financing costs with having to refinance it or the remaining term of the agreement, 20 years, that's a difference of about 46 million dollars. The Staff has made this recommendation to buy this out without having any study as to whether that is the best thing to do or not. So that's just one example of why we believe that Staff's recommendation is not a well thought out proposal to front load that and to buy out some of these things.

Q. Under the Company's treatment of PGE contract, what is the Company's position on the

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appropriate rate-making treatment for the final two years of revenue that are not affected by contract restriction?

A. As we get to that final two years, the revenues in those years would be included in rates for rate-making purposes, assuming we are in a rate case at that time.

Q. Looking now at the dispatch credit discussed in Mr. Buckley's testimony, you do not appear to object to Staff's assertion that your hydroelectric resources provide dispatch flexibility; is that correct?

A. That is correct. There certainly is flexibility in our hydro system.

Q. You have not objected to Staff's estimating that flexibility by moving half of the purchases into light-load hours and half of the sales into heavy-load hours; is that correct?

A. It is true that we do operate our system to shape transactions, and I showed yesterday this graph that shows we do shape that energy between heavy-load and light-load hours.

Q. What exhibit number is that, Mr. Norwood?

A. That's Exhibit No. 507. So yes, there is some value there, and my point to my testimony was that after you are done tweaking the pricing for this

flexibility, you need to step back and ask yourself, "Is that a reasonable price for rate-making purposes?" And that's where Mr. Buckley's analysis falls short. He included that tweak but didn't step back and say, In today's environment, are the market prices he came up with reasonable, and he recommends a purchase price of 18.8 dollars per megawatt hour for purchases, and in today's market prices, that's way below what anyone would believe we are going to have to purchase power for in this next 12 to 18 months for the rate year.
Q. That leads very nicely into my next question which is that you seem to object that your and Staff's dispatch model results are not consistent with marketplace reality; is that correct?
A. Would you ask the question again, please?
Q. You seem to object that both your and Staff's dispatch model results are not consistent with marketplace reality; is that correct?
A. I think the model runs were done some time ago.
Q. Could you say yes or no and then explain possibly, please?
A. Today, they do not reflect reality. The prices have gone up since the time that we put that together, and if I were to redo it today, and hopefully

if Mr. Buckley were to rerun his analysis today, it would show a higher cost to the Company than at the time we put the study together.
Q. So is the real problem here that the dispatch model has market price inputs that are too low?
A. Yes.
Q. If it were better calibrated to market, would you object to Staff's proposal for estimating the effect of hydroelectric dispatch flexibility?
A. I believe there should be a recognition of the flexibility and -- I was going to answer your question. What is your question again?
Q. My question was, if it were better calibrated to market, would you object to Staff's proposal for estimating the effect of hydroelectric dispatch flexibility?
A. I would answer no and explain that we are working on an hourly model, as I mentioned before, and that will reflect this adjustment that Mr. Buckley last discussed. My concern is what Mr. Buckley is taking in the context of the impacts on the Company for market prices, he's just taken this one little component and tweaked it without reflecting the fact that the overall number should be higher to begin with.
Q. Turning now to your rebuttal testimony,

Exhibit T-203 at Page 30, on Lines 24 through 27, you discuss an A and G reduction ordered by the Idaho Commission; is that correct?
     A.   Yes.
     Q.   Is the number you cite of $587,000 per year based on the Idaho adjustment in addition to the overhead cost of adjustment of $305,880 you mention at Page 30, Lines 3 through 5?
     A.   No, it is not.
     Q.   Could you clarify what the $587,080 represents, please?
     A.   The Idaho Commission in evaluating this issue developed their own estimate of what those A and G costs or the overhead costs would be related to these transactions, and they determined the system figure to be $876,000 on total system basis, and all I was representing here was that for Idaho, that represented $283,000, and the equivalent amount for the Washington jurisdiction would be $587,000, so it would not be in addition to the 305 that has already been identified.
          JUDGE SCHAER: Is there any redirect for this witness, Mr. Meyer?
          MR. MEYER: Yes, I do.

REDIRECT EXAMINATION

BY MR. MEYER:

Q. There was a question from the Chair discussing asymmetry as relating to the water year information. Does the phenomenon or does asymmetry show up in the water years, or does it show up in the results of the model?

A. The asymmetry shows up in the results of the model after you apply the market prices to the stream flow that you input.

Q. Why is that?

A. As I mentioned before, the stream flow conditions are going to vary high and low, but what we do is we take each year, 1928, for example, running that through the model, and that will produce some level of powers cost. If it's a bad water year, it will produce higher power costs, and then we run each of the 60 years, and once we are finished running the 60 years, we average the power costs, and that's where the asymmetry comes in.

Q. So does your power supply model use the years of water conditions and model the costs of each year and then average the costs for all the water years?

A. Yes, it does.

Q. Is it still the Company's position that the

rolling 40-year average is less reliable for purposes of estimating power costs for the near term?
A. Yes. As I explained yesterday, the rolling 40-year average will produce a less reliable estimate than using all the data.
Q. You were asked questions yesterday regarding replacement power costs associated with Centralia and whether those exceeded the cost of Centralia in this case. Do you recall that line of questions?
A. Yes.
Q. In this proceeding, do the replacement power costs exceed the Centralia costs by 4.1 million, approximately?
A. Yes, they do.
Q. Would you please explain, how, if at all, the cost of scrubbers affect the comparison of replacement power costs to the cost of Centralia in this case as opposed to the cost of Centralia in the Centralia sales docket?
A. Yes. In this case, the costs of Centralia are based on the 1998 test period costs, which include the cost of Centralia excluding the scrubbers. The scrubber had not been installed yet in 1998, so what we had was the old Centralia without scrubbers.
The replacement power costs from Trans Alta

are higher than that Centralia which excludes the scrubbers. In the Centralia docket, the issue was, on a going-forward basis, what will be least expensive for customers, installing scrubbers for Centralia or by replacement power, and that docket analyses showed that the replacement power costs were less expensive than installing the scrubbers and keeping Centralia, and that's the proper comparison.

MR. MEYER: Thank you.

JUDGE SCHAER: Mr. Trautman, I believe you had distributed some exhibits?

MR. TRAUTMAN: Yes. In light of the questioning on the PGE monetization, Staff has compiled an exhibit. This is a response to Staff Data Request 288, and it is only a portion of the response. I would note that the entire response is about six inches in height, and the request was for all internal memo studies, analysis, and documents relating to the amendment of or signing of a new Portland General Electric, PGE, capacity sales contract, and what we have compiled is we have a table of contents put together by the Company, and we have marked the exhibits that we believe are most pertinent that deal with the transaction, and we've also included copies of those documents, and we would move for their admission.

We have no objection if the Company wishes to supplement this response with additional items from Data Request 288.

JUDGE SCHAER: So I'm looking at, then, a document that I've marked for identification as Exhibit 225, which consists of a table of contents with certain documents identified and then with those documents; is that correct?

MR. TRAUTMAN: Right. This has the excerpted portions of the response. It has the table of contents, the data response itself, and then the attached documents.

JUDGE SCHAER: Any objection, Mr. Meyer?

MR. MEYER: I don't have objection to the excerpts that are proposed. I would reserve the right before the record closes in this proceeding to add to the record any other pertinent portions of that stack of materials that we would think necessary.

JUDGE SCHAER: I'm going to admit Exhibit 225, and if you should wish to offer any other materials, you may do so, and we will consider them then.

MR. TRAUTMAN: I have one question on recross.

RECROSS-EXAMINATION

BY MR. TRAUTMAN.

Q. You were asked a question pertaining to the PGE monetization. What was the period of time that was covered by the semi-annual results of operations that you mentioned?

A. That was for the 12 months ended June 30th, '99.

MR. TRAUTMAN: Thank you. That's all I have.

JUDGE SCHAER: Mr. ffitch, did you have any further?

MR. FFITCH: I don't have any recross. I did want to offer two items for the record. First is Exhibit 221 marked for identification, and that is a copy of Public Counsel's motion to reopen the Centralia docket that has been predistributed. I would offer that under WAC 480-09-745, Sub 3(a) and the record in the other proceeding. I've conferred with Mr. Meyer. I don't believe the Company has any objection to this document.

The additional document we did not mark as an exhibit, Your Honor, but we were asking the Commission to simply -- we'd like to offer for the record the Fourth Supplemental Order in the same docket ruling on that motion, and we predistributed that document also.

It's likely in your compilation next to Exhibit 221.
JUDGE SCHAER: Did you want that to be marked as an exhibit, or is that something you distributed as a matter of convenience?
MR. FFITCH: It doesn't need to be made an exhibit. However, a number of other orders that have been referred to have been made exhibits. I'd be just as happy for it to be marked; although, we are out of numbers I see.
JUDGE SCHAER: Why don't we mark that as a part of Exhibit 221.
MR. FFITCH: All right.
JUDGE SCHAER: Is there any objection to that?
MR. MEYER: No.
JUDGE SCHAER: Exhibit 221 is admitted.
MR. FFITCH: I have nothing further, Your Honor.
JUDGE SCHAER: I have a question for you, Mr. Trautman. I believe you waived cross of Mr. Norwood, but I thought that you had said you had some exhibits that you wished to put in. Is that something I dreamed, or is that what happened?
MR. TRAUTMAN: No. We didn't have any exhibits other than the one I just offered.

JUDGE SCHAER: So what has been marked for identification as Exhibits 218 through 220 have not been offered by anyone; is that correct?
MR. TRAUTMAN: I thought these were for Johnson, but I guess they were for Norwood. It would be just as well to offer them through Mr. Norwood.
JUDGE SCHAER: Would you like offer them then?
MR. TRAUTMAN: Yes.
JUDGE SCHAER: Is there any objection to these documents?
MR. MEYER: None.
JUDGE SCHAER: Those documents are admitted.
MR. VAN CLEVE: Your Honor, this is Brad Van Cleve, and could I ask a follow-up to a response that Mr. Norwood made to you?
JUDGE SCHAER: Why don't you go ahead, Mr. Van Cleve.
MR. VAN CLEVE: Can you hear me okay, Mr. Norwood?
THE WITNESS: Yes, I can.

CROSS-EXAMINATION

BY MR. VAN CLEVE:
Q. When I heard the answer that you just gave to

the question about the PGE contract, it left the impression that there was still capacity contract between PGE and Avista. Isn't it true that all of Avista's rights and obligations under the PGE capacity contract were assigned to Spokane Energy, LLC?
A. I'm not sure of the exact legal requirements. What I do know is that under the monetization arrangement, the Company has the same 150 megawatt obligation that it had before. As far as the legal ins outs, I'm not certain of those.
Q. Isn't it true, Mr. Norwood, that the Company's obligation is now to Enron to provide capacity and not to PGE?
A. Yes, I believe that's true.
Q. So in other words, there is no longer a contractual relationship between Avista and PGE.
A. I'm not certain of any remaining obligations between PGE and Avista, but it is true that we are delivering the capacity to Enron, and that continues on in some fashion to Portland General.
Q. Do you know which contract provides for the payments in the final two years?
A. No, I do not.
Q. Its not a payment directly from PGE to Avista, is it?

A. I don't know.

MR. VAN CLEVE: That's all the questions I have.

JUDGE SCHAER: Is there anything further for this witness? Mr. Norwood, you are excused for now. I would like you to be available tomorrow morning if there are any questions at that point. I think at this point we should take our afternoon recess.

MR. FFITCH: Your Honor, in aid of that, I would like to just advise the Bench that while Mr. Hill is available -- we do have other witnesses scheduled before him, as you know, and I've conferred with him, and we are comfortable if the Bench wishes to continue in order with the witnesses and just get to Mr. Hill in the order that we've already planned.

JUDGE SCHAER: Give me just a moment, Mr. ffitch.

(Discussion off the record.)

MR. MEYER: May we state a preference?

JUDGE SCHAER: If you would like to, go ahead.

MR. MEYER: We would prefer to go with Mr. Hill because I'm somewhat fearful that if we begin with Hill, then Lurito, then Dr. Avera, the Eliassen -- and if for whatever reason we fall off course in terms of time estimates, I can imagine the situation where we might not get done -- the other witnesses, Mitchell and Johnson and Feltes I think are flexible in their schedule. They can be adjusted, but it would be our preference to have Hill on and off today.

CHAIRWOMAN SHOWALTER: The reason we had gone the other way is the content. The brain is better in the morning.

MR. FFITCH: In terms of scheduling, I agree that's a concern tomorrow. I think our cross-examination estimate of Dr. Avera is going to be excessive, and we probably will not have as much for him, so that will help with things fitting in tomorrow.

JUDGE SCHAER: Looking at estimates for tomorrow, we have an estimate of two hours for Dr. Lurito, an estimate of one hour for Dr. Avera, and an estimate of 45 minutes for Mr. Eliassen, so that if we added the two-hour estimate for Mr. Hill to that, we would then be facing five-and-three-quarters hours estimate for the day, which may be a little excessive considering the fact that we are going to have discussion tomorrow morning on power supply issues.

MR. FFITCH: I'll just note that Dr. Avera, I think our 45 minutes is probably real generous given what we are currently expecting.

JUDGE SCHAER: Mr. Meyer, how realistic are your estimates?

MR. MEYER: I might be able to shorten up Dr. Lurito somewhat, but in part, that's a lot of cost of capital stuff to think through in one day, and if for no other reason to break it up with some sleep time in between can't hurt.

JUDGE SCHAER: It looks to me inescapable that we are going to be dealing with cost of money testimony either today in the afternoon or tomorrow in the afternoon, so why don't we then take our afternoon break, and during our break, I'd like you to have Mr. Hill take the witness stand and get organized so we can get started with him right after the break.

(Recess.)

JUDGE SCHAER: Mr. ffitch, would you like to call your witness?

MR. FFITCH: Public Counsel calls Stephen G. Hill.

(Witness sworn.)

DIRECT EXAMINATION

BY MR. FFITCH:

Q. Good afternoon, Mr. Hill. You are Public Counsel's cost of capital witness in this case, are you

not?
A. Yes.
Q. Did you prepare direct testimony and a set of exhibits which were filed in this proceeding on behalf of Public Counsel?
A. Yes, I did.
MR. FFITCH: Your Honor, those are the exhibits that have been marked for identification at Exhibits 622 through 627.
JUDGE SCHAER: Yes. I have previously marked those as Exhibit T-622 through 627, Mr. ffitch.
Q. (By Mr. ffitch) And those exhibits were prepared by you or under your direct supervision, Mr. Hill; is that correct?
A. That's correct.
Q. Do you have any changes or corrections that you wish to make to that testimony?
A. No, I do not.
Q. If I were to ask you these same questions today, would your answers be the same as they are reflected in these exhibits?
A. Yes.
MR. FFITCH: Your Honor, at this time I would offer Exhibits T-622 through 627.
JUDGE SCHAER: Any objection?

MR. MEYER: No objection.

JUDGE SCHAER: Those documents are admitted.

MR. FFITCH: Mr. Hill is available for cross-examination.

JUDGE SCHAER: Did you have questions, Mr. Meyer?

MR. MEYER: I do.

CROSS-EXAMINATION

BY MR. MEYER:

Q. I'll try and put my questions in a fairly direct fashion allowing for short answers, but I don't mean to cut you off. First, let me lay the foundation, lay the predicate, if you will, to establish what you proposed. Do you propose an overall rate of return for Avista of 8.82 percent?

A. Let me make sure that number is correct. That's correct.

Q. Are you combining a proposed return on equity of 10.875 percent with a capital structure composed of 38.97 percent common equity?

A. Yes, sir.

Q. Now, in order to arrive at your cost of equity recommendation, did you apply a cost of growth DCF model to a group of eight other gas and electric

utilities?
A. I'm sorry. I don't understand what you mean by "cost of growth DCF model."
Q. Did you use a constant growth DCF model, and that was applied to a group of eight other gas and electric utilities that you selected for your proxy group; is that correct?
A. Correct.
Q. Did you conclude in that exercise that the cost of equity for this comparable group was in the range of 10.5 to 11.25 percent?
A. Not exactly. I concluded that the reasonable range for the cost of equity for that sample group was 10.5 to 11.25 based on primarily the DCF but also three other methodologies, the capital asset pricing model, the modified earnings price ratio model, and the market to book ratio model.
Q. The final analysis, you selected what I believe you may have characterized as a midpoint estimate for cost of equity of 10.875 percent lying within that range of 10.50 to 11.25; correct?
A. Correct.
Q. In the process of arriving at that point estimate, did you include an allowance for flotation costs?

A. I did not.

Q. Did Staff Witness Lurito, to the best of your knowledge, include a 25 basis point upward adjustment for flotation costs?

A. Yes, he did.

Q. Did you, with regard to the development of your capital structure, develop, for want of a better characterization, a utility-only capital structure arrived at by subtracting Avista's investment in nonutility businesses from the equity component of the consolidated capital structure as of December 31, 1999?

A. Not exactly. I used a six-quarter average ratio, and it was not year-end, December 31st, 1999, and the only capital in the consolidated books of account of Avista belonging to the unregulated operations except for a very little bit of debt is equity, so the only way you could remove that unregulated operations from the capital structure is to subtract primarily equity from the equity capital of the consolidated entity.

Q. The equity component, just as a frame of reference in that capital structure, was approximately 39 percent. We've established that; correct?

A. Correct. That's the result of removing Avista's equity investment in its unregulated operation

from the consolidated capital structure.
Q. As a frame of reference, do you recall my mention of the eight other gas and electric utilities in your proxy group?
A. Yes.
Q. If one were to take an average cost of equity component of that group's capital structure, do you show that that would be in the range of 45 to 49 percent depending on whether one included or excluded short-term debt?
A. I think you misspoke, but I would agree with the general gist of what you are saying. You said cost of equity capital structure, and I don't think you meant to say that.
Q. Component of the capital structure is what I meant to say. Otherwise, with that clarification, would you agree?
A. Not exactly. Equity component, not cost of equity component. My analysis shows that for my companies, the average equity ratio including short-term debt is about 45 percent, and I would agree with that.
Q. Does that exclude or include short-term debt?
A. It includes short-term debt.
Q. If one were to exclude short-term debt, that

would have been higher?
A. Yes.
Q. What level?
A. I believe you said 49 percent. That's correct.
Q. Does your constant growth DCF model assume a payout ratio that is constant over time?
A. That's the basis of the derivation of the model. Anyone that uses the DCF model has that assumption as its base. In fact, your witness in the end point of his multistage DCF assumes a constant growth DCF in which the payout ratio is constant.
Q. Do you assume in your model that earnings, dividends, book value, and stock price all grow at the same rate in perpetuity?
A. No. That, however, is a basic fundamental assumption used in deriving the DCF. I recognize that those assumptions aren't met in reality and discuss that in detail in my testimony as well as in my Appendix C.
Q. Do you make an adjustment to your constant DCF model to account for that in your constant DCF model?
A. Yes, I do.
Q. I believe you testified before that with

regard to the capital structure question, Dr. Lurito and you differ, really, with respect to -- this is not cost of capital. This is cost of equity. Staff included flotation costs, and you did not; correct?

A. Correct.

Q. Now, do you recall Dr. Lurito's testimony to the effect that such a flotation cost adjustment is necessary to allow Avista Utilities to recover in rates and amounts sufficient to allow Avista Corporation to recoup some financing costs related to past common stock sales? Do you recall the essence of that testimony?

A. Yes.

Q. Mr. Hill, are corporations in the competitive sector generally financed with 100 percent equity?

A. No.

Q. Do you follow Value Line?

A. I have to.

Q. I thought so. Would you agree subject to check that the Value Line of February 4, 2000, shows that of the 827 industrial, retail, and transportation companies included in its industrial composite that the average capital structure for that group of 827 companies included approximately 39 percent long-term debt and 61 percent common equity?

A. That sounds about right.

Q. Mr. Hill, you previously presented testimony before the Maryland Public Service Commission, haven't you?

A. Yes, I did.

Q. Did you do so in Docket Number 8797 regarding Potomac Edison Company?

A. If it was a couple of years ago, that sounds like the restructuring case, yes.

Q. Now, would you agree that -- and I can provide you a copy of your testimony in that proceeding if you need to be refreshed, but would you agree that you, in that testimony, attributed a capital structure consisting of 40 percent debt and 60 percent common equity to the deregulated generating segment of Potomac Edison Company?

A. Yes. My task in that case was to determine a cost of equity for the consolidated electric operations. The transmission and distribution operations and the generation-only operations posed restructuring, so the short answer is yes.

Q. Was that recommendation on your part based on your reliance on statistics from the Value Line industrial composite similar to those I just discussed with you?

A. Yes, in part.

Q. Does a 39 percent equity ratio such as you've recommended assume a greater financial risk than a 45 to 49 percent equity ratio, all else being equal?

A. All else being equal, yes.

Q. Where in your cost of equity, cost of equity recommendation, have you adjusted upward your recommended cost of equity to account for the greater financial risk?

A. Is that the end of your question?

CHAIRWOMAN SHOWALTER: The greater financial risk of what?

MR. MEYER: The greater financial risk of a 39 percent equity ratio.

THE WITNESS: At Pages 49 through 51, I discuss other factors which I've considered in determining the equity return which would be allowed in setting rates for Avista's operations. One of those factors is the difference in the equity ratio of the two companies. I note that although the equity ratios are different -- this is common equity ratio of my sample firm is about 45 percent considering short-term debt, and for Avista's utility-only capital structure is 39 percent, but if you look at total equity capital, that is, common and preferred, those numbers for those two groups are about the same, and the bond rating agencies in determining financial risk key on a ratio called "total debt to total capital," so they focus on the debt ratios, so total debt to total capital for that sample group that I used and for Avista were about the same, so I did consider that difference in equity capital ratios, and I discussed it in my testimony.

Q. But show me in particular where you have made a quantifiable upward adjustment of your cost of equity to specifically account for the greater financial risk associated with your recommended 39 percent equity ratio, and be specific.

A. I considered other risk factors besides the capital structure risk, and in considering all of those risk factors together, I determined there was not a need to move away from the midpoint of a range, because there are other factors which mitigate that equity risk difference.

One of the facts I talked about just a moment ago, in fact, the total debt to total capital of Avista utility-only and my sample group were very similar, so that would indicate to me the financial risk is very much the same. There are other operational risk factors which make Avista less risky, so in balance, considering all the factors, I made no upward

adjustment to the cost of equity from the midpoint of the range I determined was reasonable.
Q. So I could not go to any portion of your testimony or exhibits and find a specific rifle-shot analysis, if you will, of how you adjusted cost of equity to reflect the financial risk associated with your cost of equity component of your capital structure; correct?
A. No, I disagree with that. I'm not sure what you mean by "rifle shot," but I describe there are factors to be considered in determining where in a range an allowed equity return should fall, and I've considered those on Pages 49 through 51 of my testimony.
Q. Let's turn to Page 50 of your testimony.
A. I'm there.
Q. At Lines 3 through 5, is it your testimony that quote, "Due to the differences in the common equity ratio between Avista and my sample group of firms, the Company could be said to carry somewhat higher financial risk." Is that your testimony accurately read?
A. That is one of the sentences in that paragraph accurately read, yes.
Q. Is it true that cost of equity and capital

structure decisions should be made together when the Commission issues its decision?
A. They are factors that are related.
Q. One could influence the other and vice versa?
A. Could, yes. There are many factors which impact risk. Capital structure is one of them.
Q. Mr. Hill, does the absence of a PCA imply greater risk for Avista?
A. I would have to say in the absolute, all other things being equal, yes.
Q. Don't you on Page 51 of your testimony, Lines 9 and 10, state that quote, "There may be some risk-reducing aspect related to the fact that a few of the firms included in my sample group do have power adjustment clauses." Is that your testimony?
A. Yes. That's one of the factors I considered in assessing many risk factors in determining a recommended return in this proceeding.
Q. Let's spend just a moment with some of the utilities within your sample group. Do utilities in your group, if you know, rely significantly on hydrogeneration?
A. Generally, they do not, but many of them have significant nuclear generation.
Q. Then I gather you would agree that the

utilities within your sample group do not rely as heavily as Avista on hydrogeneration.
A. That would be a correct statement.
Q. So does Avista for its part remain exposed to the impact of year-to-year fluctuations of water conditions absent a PCA?
A. Yes.
Q. Now, when we look at your group of proxy companies, would you agree subject to check that four of the eight companies in your group have some sort or some form of adjustment clause in place to accommodate for changes in fuel or purchase power costs? Would you agree subject to check?
A. Yes, I think that's correct.
Q. Of the remaining four companies within your proxy group, would you agree that three of those companies have either undergone comprehensive industry restructuring or otherwise have incentive regulation plans in place?
A. You will have to tell me which companies you are talking about.
Q. Do you know which ones of the remaining four?
A. I can't bring them to mind.
Q. We'll return to that in just a moment. Would you agree that from an investor perspective, from an

investment community perspective that absent a PCA, investors perceive increased business risk surrounding volatility in the energy marketplace, all things being equal?

A. Looking at that one indica of risk, the answer would be yes.

Q. Would you agree that exposure to this sort of power price variability has become a significant risk for electric utilities in general?

A. I don't know that I could agree with that. I think that there are some parts of the country where power cost fluctuations are severe. Southern California comes to mind, and there have been some spikes in New England also, places where the industry has been deregulated largely, but there are other large areas of the country where that's not a problem, and there are ways to mitigate that volatility. Management has at its disposal ways to hedge risk, ways to manage that risk.

Q. Mr. Hill, are you familiar with, in general terms, with the more recent history over the last few months of pricing at the Mid-C?

A. Yes.

Q. Are you also familiar with recent history over the past few months of pricing at COB?

A. No.
Q. Do you know what COB means?
A. I can't bring it to mind.
Q. California Oregon Border. Do you know what Mid-C means?
A. No. But I've seen that term used in discussions, in testimony regarding the power costs that have occurred in June and July.
Q. Do you know where the Mid-C point is?
A. No, I don't.
Q. Have you read Mr. Norwood's rebuttal testimony?
A. No, I have not.
Q. Let's turn briefly to a discussion of short-term debt. Does Avista have a need for cash in its day-to-day operations?
A. I'm sure it does.
Q. Does Avista have a need to finance short-term assets and uses of cash, such as customer accounts receivable, materials and supplies inventories, and deferred purchase gas costs?
A. I would say that's probably the case.
Q. Are any of these type of assets included presently within this utility's rate base?
A. Not that I'm aware of.

Q. Does this utility have a working capital allowance?
A. I can't say for sure, but that's not an uncommon sort of allowance to have.
Q. Do you believe it does; do you know?
A. I don't know.
Q. Let me ask you this. Should these type of items, such as customer accounts receivable, materials and supplies inventories, and deferred purchase gas costs, should they be included in the utility rate base, according to your belief?
A. My area of expertise is really cost of capital, and that's what I focus on. I don't really discuss rate base issues, per se. I don't believe those items are normally considered to be part of rate base.
Q. If these type of items that may be financed, if you will, through day-to-day cash are not included in rate base, why should the short-term debt that may be used to finance these items be included in the capital structure?
A. Short-term debt is investor supply capital. The cost of capital depends on the cost of the company of capital supplied by investors. Now, once a dollar of short-term debt or a dollar of preferred stock or a

dollar of common stock goes into the corporate treasury, it's just a dollar. We don't know where it came from. When you spend that dollar out of the corporate treasury for paper clips or for gas balances or for construction or any other corporate function, it's really not possible to trace exactly where those dollars came from, so in looking at the cost of capital to the company, I believe it's important, especially if the company uses over time a significant portion of short-term debt, that that capital be included.

I think that there are some times when in some instances I've testified in cases where companies do not use short-term debt. There are long periods of time where there is zero short-term debt balance, and in that situation, I would not recommend the use of short-term debt. I show in my exhibits to my testimony that Avista has had a sizable amount of short-term debt; although, it's lower than the other companies in my sample group. They've had short-term debt outstanding, and I think it should be considered when determining the overall capital cost.

Q. Mr. Hill, would you agree that in your Exhibit Schedule 2, if you will turn to that?

A. I'm there.

Q. You show, for example, for December of '98, a

zero balance for short-term debt. That's on Page 2 of 6.
A. That's for one month.
Q. You also show for others of the months you selected a fair amount of variability ranging from $44,400,000 to, by my reckoning, a high of $118,500,000 for those selected points; correct?
A. That's correct, and my schedule also shows that on the average, the level of short-term debt use has been increasing for the Company over the past three years.
Q. Do you believe that by definition these short-term debt requirements are permanent in the same sense that a plant investment would be permanent?
A. In some instances, short-term debt is a permanent part of capital structure. While it doesn't represent a giant piece of concrete that is going to be there long after we will, it is a part of the tools that a CFO uses to finance operations. It does represent the cost to the company of capital supplied by investors, and it is indication of what capital costs to the company, so if you ignore it, if you ignore short-term debt in rate making, the company is incentivized to overuse the current capital because they can effectively lower the overall costs by loading

up on short-term debt.

If you set rates absent consideration of short-term debt, and you say that overall cost of capital is, say, eight percent, if I can issue short-term debt for six percent, then after you allow me an overall return of eight, and I issue substantial short-term debt at six, I've lowered my overall cost of capital, and that will, in effect, raise my equity return.

Q. Mr. Hill, do you believe that Avista, in fact, is overusing or over-relying upon short-term debt if its history shows that from time to time it reduces that balance to zero?

A. I don't think that's an indica of overuse. I would answer the first part of your question by saying I think Avista's use of short-term debt is fairly moderate, but simply because it goes away one month here or there doesn't mean that's still not an ongoing part of capital structure.

If Avista issues some other form of capital, like a large debt issuance, for example, they won't have a need to go to the short-term debt market because their corporate coffers are full, so there is no need to go to the short-term debt market in that month.

Q. Mr. Hill, are you aware, or would you accept

subject to check if you are not, that the issuance of the Company's convertible preferred stock in 1998 was mandatorily convertible to common stock within three years?
A. Am I aware of that fact?
Q. Yes.
A. Yes. That's why I include that as common equity in my capital structure.
Q. Was it converted in early 2000?
A. That's my understanding.
Q. Did the Company also engage in the buyback of common shares in order to allow the Company at its option to reissue that at a later date when the stock price perhaps returned to a more reasonable value?
A. I don't know the reason the Company did it exactly, but I do know that they engaged for a period of time in 1999 in a share buyback program.
Q. Subject to check, did the Company repurchase 9.13 percent or 5.1 million shares during 1999?
A. That sounds about right.
Q. In that process, did that serve to reduce the common equity balance by approximately 88 million dollars?
A. I think if we look at my Schedule 2, Page 2 of 6, Exhibit 623, if you look at the bottom of the

page, you see in that box the utility-only capital structure, and you see equity ratios in September '98, December '98, and March of '99, ranging between 38-and-a-half and about 40-and-a-half percent equity. Those months are prior to the stock buyback program. The stock buyback program wasn't initiated until midyear, so you see what happens in midyear, June '99 to December '99, the stock ratio common equity ratio fell from 40.2 to 37.9, and as I said to you earlier, I didn't use the December '99 balances. I used the six core average, which is about 39 percent, and if you look at those figures at the beginning of the period, that's just about the midpoint of those figures.

Q.   But aren't those figures included within your average then?

A.   Yes, they are.

Q.   Mr. Hill, let's pull these two elements together with a question. We talked about the impact of the stock buyback. We talked secondly about the convertible preferred stock. Would you agree subject to check that if one were to (A), add the impact of the stock buyback, and (B), the convertible preferred stock back into the actual common equity ratio as of December 31, 1999, that the common equity ratio would have been 49 percent?

A. No.
Q. Mathematically, isn't that derived?
A. The convertible preferred is already in there. As I told you before, I recognize that because of the requirement that it be converted within three years that capital is essentially common, so I include it in the common from the get-go.
And I show you here the impact of the stock buyback, and the impact of the stock buyback on the utility-only capital structure is not as significant as what you are talking about.
MR. MEYER: May I approach the witness?
JUDGE SCHAER: Yes, you may.
MR. MEYER: The record should reflect that I'm handing to this witness a response to Data Request No. 177 from Public Counsel to the Company, so we've supplied this information to Public Counsel.
THE WITNESS: Would you like me to read it?
MR. FFITCH: Let's let counsel inquire.
MR. MEYER: The Request reads: "Referencing the Eliassen Rebuttal, lease provide the analysis which supports the testimony cited, including all data and assumptions necessary to reach the conclusions cited. Please also provide the data on a diskette in Microsoft Excel format."

Q. (By Mr. Meyer) Now, turning your attention to Page 2 of that exhibit, take a minute, if you haven't already familiarized yourself with that to do so.

MR. FFITCH: Your Honor, I'm going to make an inquiry at this point. Parties were asked to notify the Bench and each other last week at the prehearing conference of cross-examination exhibits and to mark them for identification on the record, and although I'm not yet sure of Mr. Meyer's direction with this exhibit, it appears to be employed as a cross-examination exhibit, which has not been provided to us, to the Bench, or to any other party prior to this point in time.

JUDGE SCHAER: What would you have me do because of that, Mr. ffitch?

MR. FFITCH: At this point, I'm going to object to the examination on this point because we haven't been provided with this document in advance, and the witness has not had an opportunity to review it. I frankly don't even know what's in it at this point, but it troubles me that we are starting to appear to be going down the road of cross-examining this witness on the basis of an exhibit that was not made a cross-examination exhibit in this case, so if there is an explanation here that Mr. Meyer can offer, I'd be happy to hear it.

JUDGE SCHAER: Your response please?

MR. MEYER: I think I can ease your pain a bit by noting that I had asked this witness to accept something subject to check. He said he could not. This response we previously provided to Public Counsel gives him the ability in very short order to accept subject to check the question that I put to him moments ago. It's just that simple.

JUDGE SCHAER: So are you going to ask him now if he will accept something subject to check and see what his answer is?

MR. MEYER: Yes, I am.

JUDGE SCHAER: Go ahead, Mr. Meyer.

Q. (By Mr. Meyer) If one were to capture the impact of both the stock buyback and the convertible preferred stock and capture that impact on the common equity ratio as of December 31, would you agree that the common equity ratio would have been approximately 49 percent?

A. No.

Q. If we eliminated the temporary impact of the Company's stock buyback program, would you agree that the common equity component of the capital structure at the end of 1999 would have been 38.99 percent?

A. Are you talking about Avista Consolidated rather than the rate-making capital structure for Avista Utility?

Q. You can again derive an answer, if you are willing to do so, from that response to that Data Request 177.

A. My trouble was that I understood we were talking about Avista Utility. If you are talking about Avista Consolidated, that's a different story.

Q. I'm talking about Avista Consolidated.

A. First of all, you shouldn't add back the convertible preferred because I've already done that, so when you did do that, it double counts to convertible preferred. If you add back the stock buyback, the equity ratios would you higher.

If you look at my Schedule 2, Page 2 of 6, if you look at March '99 for the consolidated entity, you see an equity ratio of about 47 percent, March '99, and the percentages at the bottom part of the top box, and I think that's what he's driving at.

Q. Mr. Hill, does the response to Data Request No. 177 capture the impact of the stock buyback program as it relates to the equity component of the Company's actual capital structure as of the end of 1999?

MR. FFITCH: Objection.

MR. MEYER: Allows for a simple yes or no answer.

JUDGE SCHAER: Go ahead, Mr. ffitch.

MR. FFITCH: The counsel is continuing to cross-examine on an exhibit which was not identified as a cross-examination exhibit. It is apparent to me, at least, that this was planned cross-examination with regard to this exhibit, rather than some sort of spontaneous assistance with a subject-to-check question, and I'm going to object to the line of questioning on the basis that we were not provided with this exhibit to review before the hearing.

JUDGE SCHAER: Mr. Meyer, any brief response?

MR. MEYER: Frankly, I wasn't anticipating having nearly this much difficulty getting a response to a subject-to-check question which is based on simple calculations.

MR. FFITCH: We're moved beyond subject to check. The witness's answer is that he disagrees, and now we are getting further probing questions on a data response which apparently the Company has planned for cross-examination on but not seen fit to identify as an exhibit, and my concern really is not even so much with the content but with the departure from the required procedures here. We obviously, for our part, made our cross-examination exhibits voluminously available to the parties, and we were advised by the Company there were no exhibits whatever for Mr. Hill in this proceeding on cross.

JUDGE SCHAER: Mr. Hill, was this document prepared by you?

THE WITNESS: No, ma'am.

JUDGE SCHAER: Do you have any independent knowledge about the information it contains?

THE WITNESS: No, ma'am.

JUDGE SCHAER: I'm going to sustain the objection at this point. Go ahead, Mr. Meyer.

Q. (By Mr. Meyer) Let's turn now to the subject of capital structure --

A. That's what we've been talking about.

Q. -- as it relates to some S and P guidelines. We haven't talked about that yet, have we?

A. No.

Q. In your testimony at Page 7, you refer to A-rate utilities when deriving your recommendation for return on equity, don't you?

A. I refer to the cost rate on A-rated utility bonds. That's something that I use as kind of a metric for where interest rates are going. I don't try to

relate it specifically to Avista in this proceeding.
     Q.   Do you mean to suggest by that testimony that you believe an A rating is the appropriate rating for Avista's utility operations?
     A.   No, I don't mean to suggest that.
     Q.   But do you believe that in any event, an investment rating would be appropriate for this company?
     A.   Yes. It's a position I've held for a long time that rates should be sufficient to, under official management to allow utilities to be able to achieve investment-grade bond rating.
     Q.   Would that rating be at least a triple B rating?
     A.   Triple B minus is the lowest rung. Triple B is the demarcation point between the investment grade and noninvestment grade. The average bond rating for electric utilities today is between A minus and triple B plus.
     Q.   I gather you are quite conversant with Standard and Poor's guidelines for standard debt ratios?
     A.   Well, I've seen the documents. I know that they revise them in June of 1999. I can't bring those ratios to mind at will.

Q. Well, barring an objection from Public Counsel, I can refresh your memory, if need be, as we proceed through this short line of questions. Would you agree that the debt ratio based on those S and P guidelines for an A-rated utility would fall generally within the 41-and-a-half to 47-percent range?
A. I wouldn't be able to confirm that unless I saw the S and P document.
Q. There is one line out of this document.
MR. MEYER: May I approach the witness?
JUDGE SCHAER: Go ahead, Mr. Meyer. I would like you also to show this to Mr. ffitch before you ask the question, please.
MR. MEYER: Glad to do it.
Q. (By Mr. Meyer) The record should reflect I'm handing the witness a document authored by Standard and Poor's. The date is June 21, '99, entitled "Utilities and Perspectives," and directing the witness's attention to Page 3, I'm not sure I got an answer to the last question. Would you agree that S and P guidelines for debt ratios for A-rated utilities fall within the range of approximately 41-and-a-half to 47 percent?
A. The line you have highlighted here is for the business position of five, which is, I would note -- I

would agree with your question and note that that is for a business position of five, and Avista's consolidated operations largely, I believe, because of their trading activities, have an overall business position of five.

It would be my expectation that the utility-only operation would have a much lower business position number. In other words, it would be less risky, and therefore, the acceptable debt ratios would be higher.

Q. Do you have any basis for that assertion other than your judgement? Could you point to any corroborating authority?

A. I certainly can. As a matter of fact, in a data response provided by your witness -- I'll get it here in a moment. It's Dr. Avera's response to our Request No. 197. It's a Moody's November 1998 document entitled "Management Strategies for Competition, Growth, and Change," and in it, it has a graph -- may I go to the easel here?

MR. FFITCH: Your Honor, I'll just note for the record that this Data Request to Public Counsel 197 has been marked for identification as Exhibit 138. He was asked to provide a complete copy of the Moody's November 1998 document, and this particular response here says, "Please refer to the response to 192," so the actual report, those are the work papers of Dr. Avera, which are several inches in depth, so my reference to Exhibit 138 isn't particularly helpful to you, I'm afraid. We do have a copy of those work papers here in Olympia. I think the Company does too, but we don't have that actual report that Mr. Hill is referring to as marked as an exhibit right at this point.

JUDGE SCHAER: Go ahead, Mr. Hill, with your answer.

THE WITNESS: In this Moody's document, it has a graph on Page 3 that depicts risk and return -- risk is on the Y axis. Return is on the X axis -- for four kinds of operations for electric utilities. The least risky operation is transportation. The next least risky is distribution. The next is generation, and the final, the riskiest, is energy marketing and trading.

So the independent support for my statement is provided by your witness and says that if Avista, which includes all of these operations, has a business rating of five, then the utility operation alone will have a lower business rating than five. (Witness indicating.)

Q. (By Mr. Meyer) Mr. Hill, are you referring to a -- what's the date of that document; is it a '98 document?
A. Yes. It's a document that your witness referred to in his rebuttal testimony, and it is 1998.
Q. Would you agree that Standard and Poor's has moved us from a business position from three to five just recently?
A. Yes, and I think that was because of the trading activity.
Q. So that's '98, but Standard and Poor's has us at a position five currently; is that correct?
A. Because of the trading company and the fact that you were three beforehand indicates to me that the utility may be even less risky than that.
Q. Let's look at the line on that Standard and Poor's set of guidelines.
A. The line you have highlighted?
Q. Yes. Let's talk a minute about what those guidelines provide under the double B category. Would that be a less than investment grade rating?
A. Double B is less than investment grade, that's correct.
MR. FFITCH: Your Honor, I'm forced to note again here, perhaps by way of an objection, that we are

walking through the -- we've moved on from the Moody's and we are back to the so-called illustrative exhibit, which was going to be shown to the witness so he could look at one number, and it now appears we are into a line of questioning on that document. It hasn't been made an exhibit or preidentified as a cross exhibit. The Commission doesn't have it available to follow. I don't have it available. We are into that same situation, Your Honor.

JUDGE SCHAER: Mr. Meyer?

MR. MEYER: I would be happy to ask this question if he doesn't need to refer to any documents. I'm merely trying to help him refresh his recollection. Let me ask the question this way: Do you know what the debt ratios are, the bracket of ranges for debt ratios for double B companies are as determined by those guidelines? You don't have to refer to them if you know it off the top. I'm trying to be helpful.

CHAIRWOMAN SHOWALTER: Why didn't you provide these documents? If you are using them in the cross-examination, why not give the rest of us the benefit of it? Why not have done that prior?

MR. MEYER: I probably should have, but this line of cross was just developed today, just that simple.

THE WITNESS: The range on the sheet you gave me was from 46 percent to 67.5 percent.

Q. (By Mr. Meyer) Is that for a double B or a triple B?

A. That's a double B.

Q. Would you turn to Page 11 of your testimony? Would you go to Lines 1 and 2?

A. Yes.

Q. Is it fair to say that you indicate there that the expected return on book equity for the electric utility industry in 1999 to 2000 is 12 to 12.5 percent?

A. Would it be fair to say that's what I say?

Q. Yes.

A. Yes, it would.

Q. Have I accurately characterized that?

A. Yes, you have.

Q. You also state that, and here, we may have to go to your Page 42.

A. I have it.

Q. Here we are at Lines 2 and 3. The long-term projected ROE, return on equity, for your proxy group is 12.63 percent; is that accurate?

A. Return on book equity.

Q. That's 12.63 percent.

A. Return on book equity, yes.
Q. This is for, as I mentioned in the question, your proxy group; correct?
A. Correct.
Q. If you were doing rate cases for any of the companies in your proxy group, would you still be recommending the same 10.875 percent cost of equity as you are recommending here?
A. Certainly would. The cost of equity is a market determining cost. The costs that you've quoted here are book value costs, simply income divided by book value. The market cost is lower because the market price investors are willing to provide for those stocks is higher than book value.
Q. Would you turn to Schedule 10, please?
A. I'm there.
MR. FFITCH: Do you have an exhibit number, counsel?
MR. MEYER: SGH 1. Is that 623?
Q. (By Mr. Meyer) Would you agree that only two of the companies as shown there have projected ROE's of less than your recommended 10.875 percent?
A. Very glad you mentioned that. Yes, I would agree with that, and that is because those two companies have market values which are below book

values, and this shows very clearly what I say in my testimony that those two parameters orbit around the cost of equity. When the market price is above book value, the earnings price I show is lower and the expected ROE is higher than the cost of capital.

When that situation is reversed, then those two parameters reverse, so they essentially orbit around the cost of capital, and that's why I used the average of those two to give me an indication of what the cost of capital is.

Q. That will help me get quicker to what I'm doing. Those two companies are CHG and RGS; correct?

A. That's correct.

Q. Turn to Page 30 of your testimony.

A. I'm there.

Q. At Lines 6 through 8, do you say, quote, "Because a goal of regulation is to allow a utility to recover no more than its cost of capital, it is also reasonable to assume that investors would expect the market price book value ratio to have a tendency towards unity"; is that your testimony?

A. That is a correct reading.

Q. Is it your position that a ratio of one, market to book, is or should be the appropriate goal of this Commission in this proceeding for this company?

A. No.
Q. In fact, in your belief from the investment community perspective, do you believe investors expect the market-to-book ratios for competitive firms to be driven down to unity or to one times?
A. I don't believe I'm discussing competitive firms. The sentence you read begins, "Because a goal of regulation is to allow..."
Q. My question goes to competitive firms. Do you believe investors expect market-to-book ratios for competitive firms to be driven to a 1.0 ratio?
A. The market prices and book values of competitive firms are not related to each other through a system of regulation, so that would not be my expectation.
Q. In what sense, if at all, in your view is regulation supposed to act as a surrogate for the competitive market place?
A. Regulation, as far as my particular bailiwick, cost of capital, is supposed to set a rate of return which is equal to the cost of capital because that is the most economically efficient way to determine profitability for these firms.
An allowed return which exceeds the cost of capital would unnecessarily enrich shareholders at

ratepayer expense, and an allowed return which understates the cost of capital would not allow the Company to attract capital to serve the customer's needs. So the most efficient run allocation of resources is to set rates based on cost of capital, because in a competitive environment, that is the return that these companies would achieve.

Q. Mr. Hill, Page 45, Lines 9 through 10, let's just take a minute to go there.

A. I have it.

Q. Do you state that, "In the current market environment with Avista common stocks selling at roughly 180 percent premium to its book value..." and then you go on. The point of this question, is your reference to that 180 percent premium to book; do you recall that testimony?

A. I'm looking at it.

Q. Of course, that was the estimate of market to book at the time you put this testimony together; correct?

A. I believe I'm quoting a February 18th Value Line. I think the stock price is somewhat below that now.

Q. Would you agree subject to check that the market-to-book ratio, if we use yesterday's closing price and the book value for the Company that you have elsewhere contained in your exhibits, is presently about 1.91 of a ratio?

A. Subject to check. You would have to show me what you are talking about, book value and market price.

Q. Go to Footnote 15 on Page 45, please.

A. The book value 9.9?

Q. So the book value you indicate there is $9.90 per share; correct?

A. Yes.

Q. Would you accept subject to check that yesterday's close for Avista was $18.91?

A. Okay.

Q. Mathematically, does that translate to a ratio of 1.91?

A. Okay, I'll accept that.

Q. You've referred to Avista's book value of $9.90. I want to be quite clear on this point, given your prior discussion about book value and unity. Should it be the objective of this Commission in this proceeding to drive Avista's stock to a $9.90 per share price so that ratio can be a one-to-one ratio?

A. I already answered that question. First of all, this commission is not studying rates for Avista

Corporation. We are setting rates for the utility operations, and my recommendation is not predicated on targeting any market-to-book ratio. I merely use market-to-book ratios and the mechanism that relates market price and book value under regulation to confirm the reasonableness of my equity cost estimates. I have no recommendation that this commission should target any kind of market-to-book ratio. However, that information is important. It's available to investors, and it impacts what the overall cost of equity capital should be.

MR. MEYER: Thank you. That concludes my cross.

JUDGE SCHAER: Any other parties have questions for Mr. Hill?

MS. TENNYSON: Staff does not.

JUDGE SCHAER: Commissioners, do you have questions?

CHAIRWOMAN SHOWALTER: No, thank you.

COMMISSIONER HEMSTAD: Just a question.

CROSS-EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. It's your position that the Commission should be looking at Avista utilities only, and therefore, hypothetical cost-of-capital structure rather than Avista Consolidated; is that right?

A. My view is that we are setting rates for Avista's utility operations. We are not setting rates where there is energy trading or prices they need to make or a return they need to make. They can make whatever they can, so that's our focus here.

My recommendation is a cost of equity based on other companies of similar risk, and in that sense, it is hypothetical, if you will. The cost of equity is, in my experience, normally determined through use of similar risk proxy companies. I recommend that you apply to a capital structure, however, which is representative of Avista's utility-only operations, and contrary to the Company's rebuttal testimony, it's not a hypothetical capital structure. It's the actual capital structure the way Avista chooses to capitalize its utility operations.

CROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. I just want to make clear. Should we be looking at the utility-only portion of a consolidated company, or should we be trying to isolate the utility portion in the same way we might look at only a regulated utility that had no other components?

A. I think that is very important in this situation to look at utility operations only, because the other operations, i.e., Avista's energy trading arm, is a risky operation. I think we've seen the results of that risk, and I have to add that there is a part of Avista Utilities that also trades power in that same sort of for-profit aspect that adds to the risk of the utility.

Now, that aspect of it I find kind of troubling, and I'm not sure how you can isolate that, because within the corporation, that risk is kind of corralled in the utility as well. I'm not sure you can eliminate that consideration. I think it is important to look at how the Company has elected to capitalize its utility operations. That's one way to isolate.

Another way to isolate it, and Dr. Avera has done the same thing, he's selected utility companies that he thought were similar in risk, and he says this at transcript Page 7, 17. Very clearly he says that he selected companies that were similar in risk to Avista's utility operations only. They don't have market trading risk. They are not into that business. They are into the utility business, and that's the cost of capital we need to be focusing on here.

The other risk they choose to incur through their trading arm or trading in the utility business, that's their choice, and I don't think that's anything ratepayers ought to be on the hook for.

Q. So you are saying that when looking at proper comparisons, you can either look at utility-only type companies or you could look at consolidated or mixed companies, but if you are going to do that, isolate as well their utility-only operations?

A. The companies we both looked at -- and several of the companies are similar -- they are not pure-play utilities. They are not 100-percent utility operations. There are very few of those out there today. Utilities throw off a lot of cash, and they've been reinvesting that cash in unregulated operations in the past 10 years, but those companies are predominantly utility operations. They have some unregulated operations, so there will be some risk in there because of that.

One of my companies is Alliant Energy. That company has a big investment in telephone operation, McLeod Telephone, and I think you are aware that telephone companies are probably riskier than electric companies, so that raises their overall risk, but I didn't believe it raised it to a degree that I couldn't use that company as a proxy for Avista's utility operations.

RECROSS-EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. Let me pose a hypothetical. Assume a company has traditional utility functions but then has gotten into substantially other and call it more risky nonregulated operations, and I suppose that's the trend today, generally, in the utilities field. At some point, does that have the consequence of actually increasing the risk factor for the regulated utility?

A. Yes. I don't think there is any question about it. It raises the cost of equity because the company, if it has a profile that includes utility and unregulated operations, it's overall risk profile, Avista's just got knocked down to a business position of five because of trading losses they had. That raises their overall risk profile and raises their cost of capital, but that's something they've elected to do outside the realm of regulation. If we use Avista's cost of equity, then ratepayers will be provided to require a return commensurate with that other risk. Utilities in the future, as they get more and more diversified, it's going to be more difficult to

eliminate that risk from consideration.
Q. That's what I was getting to. At some point as the risk increases, and it increases substantially, it ultimately has an adverse effect on the utility itself.
A. Yes.
Q. What is the Commission to do? If we ring out all of that risk, at a certain point, I suppose the consolidated utility when it goes to the market, you can't raise capital.
A. If that's the case, if you are allowing the -- and let me back up a minute. I have had some experience in the diversification specifically of forming holding companies, working with areas on the corporation commission when Tucson Electric turned into Unisource Energy. The Commission was very concerned about unregulated investments coming back to haunt them because they'd had a lot of trouble with that company over the past 20 years, and they put up some very strict guidelines about fire walls and who could issue debt to whom and who could secure debt for whom, what staff would be allowed to work with the unregulated operations, and it was very detailed and took a very long time to work out because it was very complex.
Q. The market will ignore that, won't it?

A. Yes, they will. They won't ignore. They will be aware of that structure, but they will still invest based on the fact that part of this company's utility, which is relatively safe income stream, and part of it, for example, in Tucson, they made solar panels, and that's a pretty high-risk company, but know it's tiny compared to the utility. They will take that into account.

My point of mentioning that was that not only will the equity capital costs of those unregulated operations come back to haunt regulated ratepayers, but the financial risk of those unregulated companies, like a solar panel company that goes belly up, and it has debt, even if it's nonrecourse debt -- believe me, lawsuits can find their way through the corporate veil and come back to the parent utility, so it is a problem, and we'll be dealing with it more and more. How we get it eliminated, we are just going to have to do the best we can.

RECROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. On that question, how do you eliminate it? I understand Commissioner Hemstad saying is there a point at which the reality creeps in. You can't eliminate it, and here we are in a regulated business where that is higher risk because either a different environment or the way all the utility companies are operating with their nonregulated subsidiaries or the way they are operating their regular ones. Are we just in an era that's higher risk than it used to be?

A.   I would generally have to say yes to that question, but it's due not to the way traditional utilities operate, because those operations, by and large, are -- power fluctuations in the Northeast aside, which obviously is a huge issue. But they still generate power and they still deliver through wires. Everybody still hooks up to the power grid, and that's the way things are today, and that operating risk has not changed.

In fact, the betas of utility operations have fallen over the last few years, so relative to the market generally, they are less risky than they used to be, but there is a concern about other kinds of investment. This energy trading thing is a very risky operation and it raises overall levels of his risk. That's one of the reasons neither Dr. Avera nor I use the Avista Corporation market data to try to estimate the cost of equity for the utility. We use primarily utility operations. We both felt that the cost of equity of those companies was going to be more representative of what we need to do set in this proceeding.

CROSS-EXAMINATION

BY COMMISSIONER GILLIS:

Q. To what extent does the market already consider in capitalizing risk the uncertainty of how regulators, legislators, and so forth will handle these changes in the marketplace? Your point makes sense in a theoretical sense, but does the theoretical simple utility exist in the marketplace?

A. I think in the minds of investors, they understand that that is a relatively low-risk operation. Finding it is difficult, and I think the concern is that we still need -- to be economically efficient, we need to set rates based on costs, and part of those costs are what it would cost this operation to raise capital, absent anything else, and if those other operations are higher risk, they require a higher return, and your question a moment ago about what do we do if those risky operations are very risky and are so bad that the Company ultimately can't raise capital, that is not a function of what the utility has done. The utility is still doing its same thing. They

are making money. They've got cash flow, but the parent company can't raise capital because they've gotten into an operation that is so risky that no one else will give them money.
Q. My question is more when an investor looks at financing this utility, absent the trading, which I guess is the risky piece, the investor needs to consider expectations of regulators or statutory changes or other things that might affect them in the future, how much of a fire wall there is in reality for a company that is engaged in those activities?
A. Investors are aware of that.
Q. How much does that affect the real cost of capital to a utility? In a theoretical sense of operating the utility, in the absence of the trading activity, but given investors' expectations and the reality of the marketplace, would investors judge a stand-alone being without the trading function as less risky than one that is already integrated?
A. Yes, I think they would. There are pure-play utility investments - water utilities, gas distributors, and there are now T and D utility operations that one can invest in, which are traditional economies of scale, monopoly operations, and maybe I'm not getting the gist of your question,

but there are those operations out there.

The picture is muddied when one of those is a part of a bigger company that invests in other kinds of operations; that the investor will evaluate those risks, and they will provide a dollar based on the return they are required, and they will require a higher return for their overall risk because the risks are higher. Now, whether those operations can provide the return they require, that's up to management, not up to regulation.

Q. I'm probably not explaining the question very well, but given what you just said, the appropriate proxies would be water companies and other stand-alone transportation companies and so forth, but my question is, why is that the right proxy, given a marketplace that is looking at, in reality, an electric utility company facing an uncertain future?

A. Because risk and return are directly related. We should allow a return to a utility company which is commensurate with its operating risk, and the operating risk of utility company is impacted by the state of the industry.

If everyone is deregulating, does that have an impact on even utility companies that aren't deregulating, and the answer is yes, it does. Utility companies' stock prices have kind of been in the doldrums the past few years as the kinks have been worked out. It does impact that, but your specific question as to what we should allow the utility, the proper return to be allowed the utility operation is the economically correct one, which is the cost of capital based on the risk of that operation. If the risk of the operation is higher, then the commensurate return should go up, but if the risk hasn't changed, they should get the utility cost of capital. It shouldn't be a cost of capital based on some conglomerate operation that is higher risk, because that would mean if rates were based on that return, the profitability, then utility rate payers would be, every month when they pay their electric bill, would be providing a return and subsidizing those unregulated operations. That wouldn't be economically efficient.

COMMISSIONER GILLIS: Thank you.

RECROSS-EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. Why do utilities sell at market prices that are substantially priced above book?

A. Because they are earning returns that are greater than the cost of capital. They are earning

returns in the neighborhood of 12 percent, and with the interest rate structure we have today, the cost of capital is below 11, so for a company that's going to pay you 12 on a $10-book value and you only require 11, you are going to pay more than $10.
Q. You were questioned on the issue of whether it's your position that a company should be selling its book, in effect, and you said no. I think you said no, or you may have answered, "No, they don't," but what's the difference?
A. I think the question said that it's my recommendation that this commission drive the stock price of Avista to book value, and that's not my recommendation at all. I recognize that there is a relationship in regulated operations between market price and book value at the cost of equity and allowed return, and I use that in my testimony to help support my recommendations, which are derived from DCF, CAPM, and other methodologies.
I think that the movement of market price relative to book value does tell something about the cost of capital of these companies. We referred to Schedule 10 a moment ago, which is my modified earnings price ratio. If you examine that, you see that the companies whose market price right now is below book

value, have an expected return on book, which is below what I think the cost of capital is, so that kind of supports my position that I'm not recommending any particular target, market to book ratio. That information on a theoretical basis helps support my market-based methodologies and show those are reasonable.

Q. In rate cases, the typical situation we have is competing higher guns here with their views on these interesting issues. In a certain sense, I suppose as to who is right, you can say there is the possibility of the proof being in the pudding. Is there any way of measuring, for example, where your recommendations have been adopted whether they've been proved right?

A. I was just talking to Mr. ffitch today at lunch. I was in this very seat back in 1996 with U S West, and we were talking about debt ratios and capital structures at that point in time, and the question came to me -- because my recommendation which the Commission adopted was that rates be set with a 50 percent or 52 percent equity ratio for U S West. They were requesting 60 percent or something like that, and I said that was economically inefficient.

The question came to me, Where are equity ratios headed, and I said as these companies become more deregulated, they will get rid of that equity layer because it's too expensive. It's economically inefficient for them to have that equity capital, and indeed, that is what has happened. I was just in a U S West case in New Mexico last week. They requested an equity ratio of 50 percent, which is virtually what I recommended to this commission six years ago.

Over time, it's been my experience that -- and I'm partial to my own analysis, but I think my estimates of equity costs have been reasonable, given allowed returns. Utilities are certainly able to attract capital. That has not been a problem. We've seen in the documents that Dr. Avera has provided, allowed returns have gone below 11 percent. Last year, they were 10.7 percent, something like that. These companies with those kinds of equity returns are able to attract capital because that's in the range of what investors require.

RECROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. I believe Mr. Meyers asked you about whether you had or hadn't included a flotation cost amount, and you said no, you had not.

A. That is correct.

Q. I think in your testimony you listed six reasons why you hadn't. Your first reason was that Avista common stock is currently selling for a price above book value?

A. Yes.

Q. Then you were asked about the fact that the stock price has gone down recently.

A. Yes.

Q. Does that alter your recommendation at all on flotation?

A. No, ma'am.

Q. Why not?

A. Because the stock price, I believe, you said it was $19. The book value was $9. If you want to liken the issuance cost to something that happens on bonds, for example, there are issuance costs on bonds, but there is an accounting mechanism by which those are included in the weighted average cost, but, for example, if a bond were issued, say -- let's make up a rate, a 10-percent rate, and then the next day, rates fell at five percent. Well, the value of that bond would jump up above the thousand-dollar face value because that would be a very valuable instrument. You've got something that will pay you eight percent when interest rates are five. So what happens in that case is the embedded cost rate is not going to be the coupon rate. It will be below the coupon rate, because the premium to the actual face value is such that it outweighs the issuance cost.

That's really my point here. If you want to treat it the same way bonds are treated, the premium of the market price is so great that it dwarfs any kind of adjustment you might make, and so when Avista sells a share of stock at $19, and assuming there were issuance costs of one percent, then the ultimate result is going to be that the book value of the shares is going to be increased because the stock price is so far in excess of book value, so what happens to people that are holding the stock is when Avista sells shares, it increases their book value, so it's a benefit to stock holders. There is no reason that ratepayers should provide an extra 25 basis points in return to benefit stockholders when they are already being benefited. That's one of the six reasons that I think it's unnecessary.

Q. I realize there were five other reasons. I just wondered what that did to the reasoning.

A. The stock price is lower, but it's still well above book value.

CROSS-EXAMINATION

BY JUDGE SCHAER:

Q. I have just a couple of questions, Mr. Hill. Let me start with the easy one first. On Page 54 of your testimony, at Lines 22 through 24, you reference a PR article, and the citation you give for that is to a 1994 advance sheet.

A. Yes, ma'am.

Q. I have asked our library to find a copy of that article for me, and they haven't been able to find anyone who still has the advance sheets around, and they haven't been able to find it by searching for the name, so if you can, I'd like a better citation. If you can't provide that, then I'm going to ask for a copy of the article.

A. I would be happy to provide a copy of it. I don't know the citation.

Q. As Bench Request No. 4, would you please provide a copy of that article?

A. Yes, ma'am.

Q. I'd like to explore a little bit further your discussion of flotation costs. Looking at your Reason No. 5, you say that your DCF growth rate includes an upward adjustment to equity capital cost, which accounts for investors' expectations that stock sales

would be made in excess of book value. Is that correct, or do you need a moment to look at that?
A. I recognize the quote.
Q. I'm trying to address in my own mind how the concept you express here is related to the concept of book value, and if the stock were selling at its book value, would it then be appropriate to make a flotation cost adjustment?
A. Yes. I would have much less problem making a flotation cost adjustment if the stock is selling at pro rata.
Q. A couple of other points raised in Dr. Avera's testimony that I would like to hear your response to. One was criticism that you assume that Avista's nonutility activities are financed with 100-percent common equity, which you found to be wrong. What is your response to that criticism?
A. That's not my assumption. I assume that was what the cross about the 60/40 industrial equity debt ratio was. That's not my assumption. The way that I have calculated Avista's utility-only capital structure is the same as the manner in which Dr. Avera and Avista presented that capital structure in Idaho. In fact, my recommendation in this case uses more equity less than they requested in Idaho.

The reason that I extracted primarily equity -- there is a little bit of debt. There is a little bit of unregulated debt that appears on the consolidated balance sheet but only a little bit. The primary manner in which unregulated capital appears on the consolidated balance sheet is the equity capital appears there. Let me see if I can explain it to you by drawing it.

Q. Please.

A. The balance sheet, we have assets and liabilities. We've got equity, debt. Let's keep it simple. Basically here, we've got the utility plant, the asset side, and over here, we've got the money that the utility plant is built with. In its crudest form, that's what a balance sheet is, so over here, we have a line item. This is the unregulated investment. This is Avista's balance sheet, the debt capital that appears over here, except for a little tiny amount which I removed, but all the debt capital that appears here is utility debt capital, all of it. It's the same debt capital that's supplied when they calculate their weighted cost of debt. Every issue that appears here on the consolidated balance sheet is utility debt. That means that the only capital which supports this unregulated investment, if this is removed, is equity.

So the equity that appears here on the balance sheet is unregulated and regulated equity together, so in order to get the utility-only balance sheet -- and again, this is the same way they did it in Idaho -- is to take this amount out of this equity balance. This is the unregulated investment, and that gives you a utility equity balance. That's the process I use.

So when Dr. Avera talks about he assumes a 100-percent equity ratio, I'm not assuming anything about the way Avista capitalizes its unregulated operations. All that debt capital that exists in the unregulated operations disappears in the consolidated. You don't see it on the consolidated balance sheet. The only debt that's there effectively is utility debt, so the only place this unregulated investment can be is equity, so that's why you remove it from equity capital. (Witness indicating.)

Q. You were also criticized for failing to adjust your return-on-equity recommendation to account for the greater risk associated with your proposed capital structure, and I believe there was quite a bit of cross on that already, but is there anything further that the Commission should know about that?

A. First of all, my recommended capital structure is the capital structure with which Avista has elected to capitalize its utility operations. It's not something that I derive hypothetically. It's derived from the Company's own balance sheets, and it represents the way that the CFO has chosen to capitalize those operations, and it's been that way for several years. It's projected to continue to be that way, so it is a fair representation of their capital structure.

Now, as to the issue of the financial risk differences, I think we've covered that in cross. I mentioned that the equity ratio of my sample companies is higher than 39 percent. It's 45 percent, but the total equity ratio of Avista and the companies in my sample group is about the same. By totally equity ratio, I mean common and preferred equity, so that means that the total debt ratio of Avista is about 51 percent, and it's about the same for my sample group of companies, so in that sense, there really is not much difference, but I do recognize in my testimony that because of the equity ratio difference, I would say that Avista has a little more financial risk, but there are other offsetting risk factors which I consider also which mitigate that risk.

CHAIRWOMAN SHOWALTER: Can you just state what they are qualitatively?

THE WITNESS: The Company's operations are a low risk, and relative to other utility operations, i.e., nukes, that kind of thing, and their relative prices are very low. This is an economically vibrant part of the world. Unlike where I come from in West Virginia, people actually have jobs here. That all goes to the risk of the operations.

JUDGE SCHAER: Any redirect, Mr. ffitch?

MR. FFITCH: No, Your Honor.

JUDGE SCHAER: Anything further for this witness? Thank you for your testimony, Mr. Hill.

MR. FFITCH: Your Honor, I just need to inquire whether the Commission wishes to have the charts made as part of the record as illustrative exhibits.

JUDGE SCHAER: I think that would be very helpful, Mr. ffitch. If we could somehow reduce those to an eight-and-a-half-by-eleven copy, I'd bring those in perhaps tomorrow morning.

THE WITNESS: Would you like me to make a better representation as to what's up there?

JUDGE SCHAER: It needs to be something we can read the transcript and follow. It doesn't need to be real pretty. It would be helpful to have it in a size that we can refer to.

COMMISSIONER HEMSTAD: It's obviously for illustrative purposes so his testimony can be better understood.

JUDGE SCHAER: It's not going to be a substantive part of the record, but it is going to be helpful. Why don't we go ahead and mark those two things for identification as Exhibits for Illustration 628 and 629.

Tomorrow, we will start up with Dr. Lurito. Then we will have Dr. Avera, and then Mr. Eliassen. I have been asked by the accounting advisor to ask Commission staff to make sure that the errata filed by Mr. Parvinen get filed electronically. That will probably be useful for all parties involved, and I would like to remind the parties that they need to be ready tomorrow morning to discuss one of your issues, which means hopefully that they will be meeting to talk about those tonight and to explore the options outlined by the Commissioners earlier today or settlement options or anything else that may reasonably resolve that issue and be prepared to address that again tomorrow morning at 9:30.

Is there anything else we need to discuss before we go off the record? Hearing nothing, we will resume this hearing then tomorrow morning at 9:30. We are off the record.

(Hearing recessed at 5:10 p.m.)