BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

v.

AVISTA CORPORATION D/B/A AVISTA UTILITIES

DOCKET NOS. UE-110876 and UG-110877 (*consolidated*)

DIRECT TESTIMONY OF DAVID E. DISMUKES, PH.D. (DED-1T)

ON BEHALF OF

PUBLIC COUNSEL

FEBRUARY 24, 2012

DIRECT TESTIMONY OF DAVID E. DISMUKES, PH.D. (DED-1T)
DOCKET NOS. UE-110876 and UG-110877 (*consolidated*)

TABLE OF CONTENTS

PAGE

DIRECT TESTIMONY OF DAVID E. DISMUKES, PH.D. (DED-1T)
DOCKET NOS. UE-110876 and UG-110877 (*consolidated*)

EXHIBIT LIST

Exhibit No. DED-2	Summary of Background and Experience of David E. Dismukes, PH.D
Exhibit No. DED-3	U.S. Average Residential Use Per Customer Natural Gas and Electric
Exhibit No. DED-4	Revised NWEC Financial Impact Analysis
Exhibit No. DED-5	Estimated Lost Revenues
Exhibit No. DED-6	Selected Examples of Proposed ROE Adjustments
Exhibit No. DED-7	Southern Connecticut Gas ROE Comparison
Exhibit No. DED-8	Avista Corporation Change in Customers and Usage
Exhibit No. DED-9	Lesh Report, Summary of Results
Exhibit No. DED-10	Ratepayer Protection Mechanisms

I. INTRODUCTION

Q: Would you please state your name and business address?

A: My name is David E. Dismukes. My business address is 5800 One Perkins Place Drive, Suite 5-F, Baton Rouge, Louisiana.

Q: Would you please state your occupation and current place of employment?

A: I am a Consulting Economist with the Acadian Consulting Group (ACG), a research and consulting firm that specializes in the analysis of regulatory, economic, financial, accounting, statistical, and public policy issues associated with regulated and energy industries. ACG is a Louisiana-registered partnership, formed in 1995, and is located in Baton Rouge, Louisiana with additional staff in Los Angeles, California, and Fallon, Nevada.

Q: Do you hold any academic positions?

A: Yes. I am a Professor, Associate Executive Director, and Director of Policy Analysis at the Center for Energy Studies at the Louisiana State University (LSU). I am also an Adjunct Professor in the E. J. Ourso College of Business Administration (Department of Economics), an Adjunct Professor in the School of the Coast and the Environment (Department of Environmental Studies), a co-director of the Coastal Marine Institute, and member of the graduate faculty at LSU. My primary responsibilities at LSU in these various capacities include teaching, conducting service activities, administering and supervising the work of various research units, and conducting my own research in energy and environmental policy issues.

Q: Have you prepared any documents outlining your qualifications in energy and regulated industries?

A: Yes. Exhibit No. DED-2 to my testimony provides my academic vita that includes a full listing of my publications, presentations, and pre-filed expert witness testimony, expert reports, expert legislative testimony, and affidavits.

Q: Have you prepared any other exhibits to support your testimony?

A: Yes. I have prepared nine exhibits in support of my testimony.

Q: What is the purpose of your testimony?

A: I have been retained by the Washington Office of the Attorney General, Public Counsel Division (PC), to provide an expert opinion on the revenue decoupling proposal offered by Mr. Ralph C. Cavanagh on behalf of the Northwest Energy Coalition (NWEC).

Q: How is the remainder of your testimony organized?

A: My testimony is organized into the following sections:

- Section II: Summary of Recommendations
- Section III: Revenue Decoupling Overview
- Section IV: The NWEC Proposal's Inconsistencies with the Commission's Revenue Decoupling Policy Statement
- Section V: Conclusions and Recommendations

II. SUMMARY OF RECOMMENDATIONS

Q: What are your recommendations regarding NWEC's revenue decoupling proposal?

A: I recommend that NWEC's proposed revenue decoupling mechanism be rejected, due to the following:

- The proposal is based upon an incorrect premise that is contrary to state law and fundamental regulatory principles.
- The proposed mechanism would shift revenue recovery risk associated with changes in the economy, price, and other factors away from the Company and its shareholders and onto ratepayers. Such a shifting of risk, without any corresponding mitigation measures, will result in rates that are not fair, just, and reasonable.
- The NWEC proposal fails to address the multiple issues and requirements raised in the Commission's Policy Statement.

Q: Can you please explain how NWEC's proposal fails to address the requirements for revenue decoupling outlined in the Commission's Policy Statement?

A: Yes. The NWEC proposal fails to adequately address a number of full decoupling policy preferences that were clearly enumerated in the Commission's Policy Statement,[1] including the following points:

- The proposed mechanism does not condition revenue decoupling recoveries on Avista's energy efficiency performance.
- The proposed mechanism fails to address the Commission's concerns that revenue decoupling, while addressing an asserted conservation disincentive

[1] *In the Matter of the Washington Utilities and Transportation Commission's Investigation Into Energy Conservation Incentives,* Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities To Meet Or Exceed Their Conservation Targets, Docket No. U-100522 (hereafter *Policy Statement)*.

for utilities, could create other significant undesirable incentives and outcomes such as risk shifting and inefficiency, contrary to fundamental regulatory policy.

- The proposed NWEC mechanism fails to include any evaluation or adjustment for the risk-shifting nature of revenue decoupling.
- The proposed NWEC mechanism rejects the use of an earnings test.
- The proposed NWEC mechanism does not adequately address the risk shifting nature of its inclusion of weather-related changes in revenue.
- The true-up mechanism associated with the proposal:
  - Is limited to a select group of customers.
  - Fails to adequately account for "found revenue margins" associated with customer growth.
  - Fails to adequately account for gains from off-system sales.
- The proposed NWEC mechanism is not tied to any incremental energy efficiency savings that would arise from the mechanism's implementation, nor does it provide any evidence that such savings would occur.
- The proposed NWEC mechanism does not adequately address the potential impact of revenue decoupling on low-income households.
- The mechanism does not include adequate ratepayer protection provisions.

III. REVENUE DECOUPLING OVERVIEW

Q: Would you please outline NWEC's proposal for full electric decoupling?

A: Yes. NWEC is proposing that the Commission require Avista Corporation (Avista) to implement a full decoupling mechanism associated with Avista's retail

electricity sales.[2] Mr. Cavanagh describes NWEC's proposed revenue decoupling mechanism in his direct testimony. In summary, NWEC proposes a form of full decoupling commonly referred to as revenue per customer (RPC) decoupling. Under this mechanism, actual (non-weather-normalized) RPC collected by Avista would then be annually trued up against a revenue benchmark established as the allowed revenue requirement established in the most recent rate case. Revenue surpluses are credited back to customers while revenue deficiencies are recovered through a volumetric-based surcharge on customer bills.

Q: Why is NWEC proposing revenue decoupling?

A: The rationale for NWEC's revenue decoupling proposal is primarily premised upon a view that traditional ratemaking methods discourages utilities from investing in energy efficiency and conservation measures. According to NWEC, volumetric-based rates tie revenue recoveries to sales, and energy efficiency-induced reductions in sales cause revenues to fall, thereby reducing a utility's ability to earn a return on and of its prudently-incurred investments. NWEC asserts that decoupling, and specifically full decoupling, would sever the link between a utility's ability to recover its revenue requirement and the amount of electricity the utility sells.[3]

[2] Direct Testimony of Ralph Cavanagh, Exhibit No. RCC-1T, p. 2.
[3] Exhibit No. RCC-1T, p. 5: "Under traditional regulation, utilities are discouraged from investing in the best performing and lowest-cost resource—energy efficiency—because it hurts them financially. Fortunately, there is a simple, effective, and proven way to remove this conflict: break the link between the utility's revenue and the amount of energy it sells by adjusting rates to ensure that the utility collects no more and no less than its authorized fixed costs."

Q: Do you agree with NWEC's assertions that utilities inherently have a throughput incentive, i.e., an incentive to encourage electricity consumption, and not to be supportive of conservation and energy efficiency?

A: No. I particularly disagree with the assertion that utilities "are discouraged from investing in…energy efficiency."[4] It is my understanding, from a policy perspective, that the promotion of energy efficiency is Washington state law as codified in the Energy Independence Act (EIA), RCW 19.285. NWEC's assertions that, absent decoupling, utilities would somehow offer less support for conservation and energy efficiency is tantamount to stating Avista and other Washington utilities have an incentive to intentionally not comply with state law. NWEC ignores the basic fact that the EIA requires eligible utilities, including Avista, to "pursue all available conservation that is cost-effective, reliable, and feasible."[5] In other words, this statute requires Washington utilities to pursue energy efficiency. In fact, the direct incentive to pursue energy efficiency goes even further since utilities that fail to comply with energy conservation or renewable energy targets are subject to a penalty of $50 per MWh.[6] Thus, the NWEC proposal attempts to addresses an issue that simply does not, or at least should not, exist in Washington.

Q: Does NWEC's position seem out of touch with not only the EIA, but traditional rate of return regulation and the principles associated with what is commonly referred to as the regulatory compact?

[4] Exhibit No. RCC-1T, p. 5.
[5] RCW 19.285.040(1).
[6] RCW 19.285.060(1).

A: Yes. NWEC's position could easily be construed as representing a belief that Washington's regulated utilities, absent revenue decoupling, have some "inherent" entitlement to sell and waste as much electricity and natural gas as they believe is profitable for their shareholders. There is nothing inherent in the theory or practice of utility regulation that supports such a position. In fact, an argument could be made that utilities indiscriminately pushing inefficient electricity or natural gas sales are acting imprudently, irrespective of any broader state energy efficiency goals, policies, or agendas. Recently, the Indiana commission, which previously allowed revenue decoupling for its regulated gas utilities, rejected its first revenue decoupling application for a regulated electric utility (Vectren-South) based, in part, upon the finding that:

> Vectren South operates "in the public interest" not only because it provides basic and necessary customer service, but also because it extracts and utilizes valuable natural resources in providing that service…intentionally wasting those natural resources is inconsistent with this public interest standard and the promotion of inefficient sales for profit is simply inconsistent with an underlying public interest principle of close to 100 years of utility regulation. We agree, *whether Vectren South receives a particular cost recovery mechanism or not, it remains obligated to conserve resources as part of its regulatory bargain*.[7]

Q: What are the purported disincentives to promote energy efficiency?

A: Decoupling proponents often argue that current regulatory pricing practices discourage utility-sponsored energy efficiency (EE) programs. These advocates argue that energy efficiency reduces sales, thereby reducing a utility's ability to

[7] *In re: Petition of Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc.,* Indiana Utility Regulatory Commission, Cause No. 43839. Order at 83 (April 27, 2011). (Emphasis added.)

recover its fixed costs. Revenue decoupling removes the relationship between sales and revenues, and in doing so, theoretically removes the claimed disincentive utilities have for promoting end-user energy efficiency.

Q: Are sales decreases due to energy efficiency the only reason that test year (allowed) and actual revenues differ?

A: No. There are a variety of factors that can influence sales between rate cases. Consider that test year retail sales and revenues in a rate case are usually based upon a "typical" year, and as such, are based upon typical factors such as the weather, the economy, and prices, among other things. In any given year, the actual performance of the economy may differ from the test year. Weather may be colder or warmer than the historical normal weather trends included in the test year, and other factors may occur in any given year that impact sales differently than what was anticipated in the test year determination. The differences in sales created by weather, the economy, commodity prices, and other factors usually account for greater changes in revenue than those resulting from utility-sponsored energy efficiency programs.

Q: Who traditionally bears the risk associated with changes in sales revenue?

A: The utility and its shareholders typically bear the risk of changes in revenue and sales for a number of different reasons. First, it is the utility's responsibility to propose a typical year for rate-making purposes. It would not be in the best interest of a utility or its shareholders to propose a test year that was unsupportive of what management believed was required to recover costs and earn its allowed return. Second, a utility's allowed rate of return, like that of any other business,

includes some premium for the business risk inherent to the industry in which it operates.

Q: Are natural gas and electric utilities facing similar use per customer trends?

A: No. While most natural gas utilities have seen use per customer (UPC) trending downwards over the past several years, electric utilities have not been facing similar decreasing UPC trends. In fact, electric utilities have seen UPC trends that generally move in opposite directions from those seen in the natural gas industry, although data for 2008 and 2009 are heavily influenced by decreases very likely attributable to the economic recession. The chart in Exhibit No. DED-3 compares overall U.S. electric and natural gas UPC trends over the past 19 years. While electric UPC has been generally increasing over this same period, natural gas UPC has been generally decreasing. Residential UPC for Avista, as will be discussed later in my testimony, has been relatively flat over the past decade, particularly prior to the last recession.

IV. NWEC PROPOSAL'S INCONSISTENCIES WITH THE COMMISSION'S REVENUE DECOUPLING POLICY STATEMENT

Q: Does the NWEC proposal adequately address the Commission's Policy Statement on revenue decoupling?

A: No. As noted in the Summary section of my testimony above, the NWEC proposal fails to address the multiple issues and requirements raised in the Commission's Policy Statement. I will now discuss these flaws in more detail.

A. Revenue Decoupling and Performance.

Q: Can you explain the Commission's first and primary requirement for revenue decoupling in its Policy Statement?

A: Yes. The Commission's Policy Statement clearly stated that revenue recovery associated with any approved revenue decoupling mechanism will be "conditioned upon a utility's level of achievement with respect to its conservation target."[8] The NWEC proposal, however, is a full revenue decoupling mechanism that would allow Avista to recover revenues from changes in sales regardless of the source or rationale of those revenue changes and regardless of the level of the Company's energy efficiency performance. Under NWEC's proposal, Avista would be allowed to recover revenue deficiencies created by an economic contraction, or surge in energy prices, regardless of whether the Company met its conservation targets under the EIA[9]. Unconditional revenue recovery under a revenue decoupling mechanism has been rejected by the Commission on several occasions including in its Policy Statement and in the Commission's review of the pilot revenue decoupling mechanism established for Avista's natural gas operations.

Q: Should a utility be made whole for all revenue losses associated with energy efficiency programs?

A: No. Where adopted, revenue decoupling has been justified as promoting energy efficiency, not as creating a guaranteed utility revenue entitlement. In fact, this

[8] *Policy Statement*, ¶ 28.
[9] *In the Matter of Avista Corporation's Ten-Year Achievable Potential and Biennial Conservation Target Under RCW 19.285.040 and WAC 480-109-010*. Order 01, Docket UE-100176, May 13, 2010.

Commission was very clear in noting this in its Order concluding the Avista natural gas revenue decoupling review:

> The Company argues that its decoupling mechanism is necessary to allow the recovery of fixed costs approved in the most recent general rate case. *We disagree that decoupling's purpose is so broad.* The regulatory construct for decoupling in Washington has centered on the utility's performance relative to conservation….*We seek to avoid guaranteed recovery of lost margin that would occur should lost margin from other causes be included in the mechanism*.[10]

Q: Was this finding re-iterated in the Commission's Policy Statement?

A: Yes. In discussing the Cascade pilot decoupling mechanism in the Policy Statement, the Commission re-iterated and clarified its position by noting:

> Nevertheless, we believe it reasonable to *articulate now our support for limited decoupling designed to compensate a natural gas utility for the effects of its conservation program*. After our evaluation of the Cascade pilot and the company's recent filing, we may revisit the natural gas limited decoupling principles enunciated in this policy statement.
>
> We also deem it useful to articulate now our policy on this type of lost margin recovery mechanism because the Legislature has directed us to consider policies that address the revenue impacts of utility-sponsored conservation programs. RCW 80.28.260(3) states:
>
> > The commission shall consider and may adopt other policies to protect a company from a reduction of short-term earnings that may be a direct result of utility programs to increase the efficiency of energy use. These policies may include allowing a periodic rate adjustment for investments in end use efficiency or allowing changes in price

[10] Dockets 090134 and UG 090135, consolidated. Washington Utilities and Transportation Commission v. Avista Corporation, d./b./a. Avista Utilities. Order 10: Final Order Rejecting Tariff Filling; Approving and Adopting Multi-Party Partial Settlement Stimulation; Deferring Lancaster Costs; Extending Decoupling Mechanism; Authorizing Tariff Filing; and Requiring Compliance Filing, December 22, 2009. Final Order at 291 (Emphasis added).

> structure designed to produce additional new revenue.
>
> It is precisely this type of mechanism – designed to protect a company from loss of earnings *that are a "direct result" of the company's conservation programs*, both programmatic and educational – that we adopted in the Avista case and we endorse here [in the Policy Statement] for all gas utilities.[11]

Q: Are the Commission's natural gas revenue decoupling findings relevant to revenue decoupling for electric utilities?

A: Yes. While the Commission's Policy Statement creates an opportunity to consider a "properly constructed full decoupling mechanism," it does not abandon the Commission's principles expressed in the Avista natural gas decoupling proceeding that revenue decoupling should be tied to energy efficiency performance. While the Commission's definition of full decoupling is based upon changes in average use per customer "regardless of cause, including the effects of weather," the Commission later clarifies, relative to full revenue decoupling for electric utilities, that "revenue recovery by the company under the [full revenue decoupling] mechanism will be conditioned upon a utility's level of achievement with respect to its conservation target."[12] Therefore, the Commission expects both forms of revenue decoupling ("full" and "limited") to be tied specifically to a utility's energy efficiency performance. The one component that appears to differentiate "full" versus "limited" revenue decoupling is the inclusion of weather in a "full revenue decoupling" mechanism. Full revenue decoupling does not suggest that energy efficiency performance should be neglected or

[11] *Policy Statement,* ¶15-17 (Emphasis added).
[12] *Policy Statement*, ¶ 28.

overlooked, and yet this is exactly what is recommended in NWEC's proposed decoupling mechanism.[13]

Q: Does NWEC's revenue decoupling proposal shift any of Avista's energy efficiency performance risk away from itself and onto ratepayers?

A: Yes. The NWEC proposal would allow Avista to recover lost revenues regardless of source and regardless of its energy efficiency performance: this is entirely inconsistent with the Commission's policies for both natural gas and electric utility decoupling. The Commission's Policy Statement unequivocally ties revenue recovery to a utility's energy efficiency performance. NWEC's revenue decoupling proposal would allow the Company to assess customer surcharges regardless of its energy efficiency performance. While the EIA, admittedly, includes some offsetting penalties for non-performance, the NWEC proposal eliminates an important regulatory tool the Commission can use to reinforce the EIA's policy that create consequences for failures to meet energy efficiency goals and targets.

B. <u>Revenue Decoupling, Regulatory Lag and Efficiency</u>.

Q: What were the some of the Commission's concerns with full revenue decoupling?

A: The Commission noted it its Policy Statement that, while there may be potential benefits associated with "full revenue decoupling," adoption of such a mechanism gave the Commission "pause for two reasons."[14] The Commission noted in its policy statement that "with full decoupling comes a concern that, by eliminating

[13] Exhibit No. RCC-1T, pp. 19-20.
[14] *Policy Statement* ,¶ 25.

the risk of recovery of declines in revenue, combined with an energy cost recovery mechanism that reduces an electric utility's financial risk due to changes in power costs, the utility could lose some of its incentive to manage the company in a manner that constantly looks to reduced costs."[15]

Q: Does the NWEC proposal adequately address the Commission's concerns about utility operating efficiencies?

A: No. As noted earlier, the Commission's Policy Statement expressed concerns that revenue decoupling could lead to utility inefficiencies. The Commission's Policy Statement correctly notes that regulatory lag actually sends positive incentives to utilities by requiring them "…to manage variations in sales and energy costs (as in the power cost adjustment mechanisms) or decline in sales due to conservation rather than passing the costs or surcharges direct to the ratepayer."[16] NWEC's revenue decoupling proposal is premised upon a finding that regulatory lag is somehow bad, and that, when coupled with a policy of encouraging end-use energy efficiency, prevents a utility from recovering its operating expenses and its opportunity to earn a return on its investments. NWEC uses an incorrect and exaggerated example to justify its position that the combination of regulatory lag and energy efficiency prejudices utility earnings.

Q: Please discuss the NWEC example in more detail.

A: In Exhibit No. RCC-2, attached to the Direct Testimony of Mr. Cavanagh, NWEC purports to shows that 80 percent of Avista's fixed-cost revenue requirement is recovered through variable energy charges, and that every one percent reduction

[15] *Policy Statement,* ¶ 26.
[16] *Policy Statement*, n.40.

in electricity sales cuts the utility's fixed cost recovery by more than $2.5 million. The analysis, however, suffers from a number of flaws and is inconsistent with the Commission's Policy Statement.

Q: Can you explain why the NWEC financial analysis is flawed?

A: Yes. The NWEC example is flawed for two reasons. First, NWEC overstates the total fixed revenue requirement likely impacted by its specific revenue decoupling proposal. Second, the NWEC financial impact analysis fails to incorporate any potential found revenues that would likely offset any lost base revenues associated with the Company's energy efficiency efforts. Exhibit No. DED-4 provides a revised financial impact analysis that corrects for these two deficiencies.

Q: Can you please describe the first error in NWEC's financial analysis?

A: Yes. NWEC's proposed revenue decoupling mechanism is designed to exclude Extra Large General Service customers (Schedule 25). NWEC has based this exclusion upon the fact that the class has relatively few customers, and, presumably, has a relatively small sales/revenue impact on the Company's overall earnings. If this is truly the case, then NWEC has overstated the revenue impact of the Company's efficiency efforts since that class' revenues are included, not excluded, from the analysis. If this is not the case, and the revenue losses associated with the Company's energy efficiency activities directed at Schedule 25 customers is significant, then NWEC is simply proposing an unfair and discriminatory shift in costs that will result in smaller customer classes subsidizing this larger customer class.

Q: Can you please discuss the second error in NWEC's financial analysis?

A: Yes. The NWEC financial analysis fails to consider the opportunity for "found margins" associated with potential off-system bulk power sales or avoided energy purchases consistent with the Commission's Policy Statement. I have used three different methods to evaluate these bulk power opportunities.

Q: Can you discuss the first method you used to evaluate Avista's bulk power system opportunities.

A: Yes. The first method compares the opportunity of making a one percent increase in off-system sales to the potential one percent avoidance of a purchased power. This method assumes that these two opportunities are substitutable. The information provided by the Company to NWEC suggests that a one percent revenue gain associated with avoiding a one percent change in purchased power is significantly greater than a one percent gain on making an off-system sale. Based on these relative differences, Avista could reduce ratepayer costs by about $868,540 in avoided purchased power and transmission expenditures through its energy efficiency efforts. This avoided cost (benefit) needs to be considered as an offset to the Company's anticipated lost revenues.

Q: Can you discuss the second method you used to estimate bulk power system opportunities?

A: Yes. The second method I used disregarded the opportunities for avoiding purchased power and instead used the anticipated changes in the Company's revenue requirement through a one percent increase in off-system sales. I

estimate a potential found margin revenue offset from an off-system energy sale of about $411,310 using this approach.

Q: Can you discuss the third method you used to estimate bulk power system opportunities?

A: Yes, the third approach I utilized was more forward-looking, and considered a range of potential gains the Company could make, based on historic trends, for its off-system sales. Average off-system sales margins were estimated using data reported in the Company's FERC Form 1 over the past six years. These margins ranged between $17/MWh to $20/MWh over the past six years depending upon whether the most recent year, representing a bit of an outlier, is included. Given these anticipated (average) off-system sales margins, the Company could generate an additional $1.0 million to $1.2 million in additional revenues to off-set downstream revenue losses at the retail level.

Q: Have you estimated any revised net financial impacts that more accurately reflects the Company's anticipated energy efficiency efforts and the Commission's Policy Statement?

A: Yes, and as mentioned earlier, this is provided in summary form in Exhibit No. DED-4. Thus, using the NWEC financial impact framework, I estimate net revenue losses associated with Avista's EIA energy efficiency activities to likely be in the range of about $1.86 million to $1.17 million, or between 0.41 percent to 0.26 percent of the Company's total revenues. These estimates are based upon Avista's planning estimates of anticipated conservation program achievement, and therefore no analysis has yet been done to determine whether actual customer

usage has declined as anticipated due to utility sponsored conservation programs. In addition, these revised financial impact estimates do not reflect any potential "found margins" from new customer usage or increased usage by existing customers as required in the Commission's Policy Statement.

Q: How do these net revenue impacts compare to the pro forma adjustment proposed by Avista in its last rate case?

A: My estimates compare favorably since the Company's own net annualized revenue lost estimates were only $1.34 million per year for a full two year period. This is the amount proposed by the Company in this rate case (for a total of $2.67 million for two years of energy efficiency savings). I discuss the pro forma adjustment proposed by the Company in this rate case in greater detail later in my testimony.

Q: Do you agree with NWEC's assertions that these revenue losses compound and get worse over time?

A: Not necessarily. As the Commission recognized in several places in its Policy Statement, there are a variety of other offsetting factors that can influence total revenue recovery. NWEC's financial impact analysis also fails to recognize or incorporate any of the promised longer-run dynamic cost reducing aspects of energy efficiency. The efficacy of energy efficiency as an energy resource becomes challenging if it fails to deliver net overall benefits (including to non-energy efficiency program participants) over time. Yet this is exactly what the NWEC financial impact model assumes. Under NWEC's analysis, energy efficiency operates as a mechanism that leads to long-term stranded costs,

creating little or no benefit for non-participating customers. This leads to a transfer of wealth (or intra/inter class price discrimination), short term operating cost inefficiencies (by moving a regulated monopoly up its declining average cost curve), and an unnecessary stranding of costs. Making utilities whole for undocumented revenue losses, not tied to their energy efficiency performance, further compounds a problem likely to lead to long term operating and capital cost inefficiencies.

Q: Have you estimated the potential lost revenues associated with the Company's energy efficiency goals?

A: Yes. Exhibit No. DED-5 provides an estimate of the lost non-fuel revenues associated with the Company's historic and projected energy efficiency efforts. These estimates do not include any adjustments for potential found revenues that I discussed earlier outlining a number of important revisions to NWEC's financial impact analysis. My estimates of the lost base (non-variable cost) revenues ranges between 0.41 percent to 0.75 percent of total revenues.

Q: Even if NWEC's assertions were correct, do utilities have a remedy should earnings become compromised by its energy efficiency efforts?

A: Yes. Utilities have the ability to file a rate case should they believe their opportunity to earn a return on and of their prudently incurred investments and expenses are compromised. Avista has consistently taken advantage of this rate case opportunity over the past several years. The pursuit of energy efficiency, even aggressive energy efficiency, does not change that fundamental fact of utility regulation.

Q: Is there any merit to NWEC's argument that revenue decoupling prevents ratepayers from spending "too much" for their distribution service?[17]

A: No. The argument that revenue decoupling somehow prevents ratepayers from paying "too much" for their service, or prevents a utility from receiving "too much" for providing service is simply misplaced and highlights the single-issue ratemaking nature of revenue decoupling. Rate of return regulation is about regulating (and preventing) excess profits not revenues. Without regulation, a monopoly utility would simply set its prices too high, and offer too little of its services to the market in order to attain an "excessive" (or above-normal) profit. Regulated rates, from a very general perspective, are simply set at average costs and include an opportunity to earn a reasonable rate of return in order to correct for what could otherwise be considered a market failure. In any given year, revenues, costs, and profits are going to vary above and below test year levels. While costs and revenues can move up and down in any year after a rate case, it is the movement of profits that ultimately determine whether or not a utility is over or under-earning its authorized rate of return. So, the fact that revenues collected in any given year are above those in the test year does not necessarily mean that ratepayers are paying "too much" for utility service provided that the regulated utility in question is providing safe, reliable, and economic service, and not earning more than its allowed rate of return.

[17] Exhibit No. RCC-T, p. 14; "The most important point to emphasize is that neither full decoupling in general nor my proposal in particular add any additional costs to low-income customers' bills; they simply ensure that previously approved fixed costs are neither over- nor under-recovered. If any party to this proceeding thinks low-income customers are paying too high a share of Avista's costs of service, decoupling does not add to the problem."

C. Revenue Decoupling and Risk Shifting.

Q: Does the NWEC proposal adequately address the Commission's requirement that risk and ROE impacts associated with revenue decoupling be examined?

A: No. NWEC proposes to simply pass through to customers any cost savings associated with changes in Avista's cost of capital and capital structure following adoption of the proposed decoupling mechanism. There is no explanation of how this would be accomplished. Absent an explicit mechanism, any savings would be passed back to shareholders. NWEC contends that prospective adjustments in utility authorized ROE should not be a part of decoupling, since: (1) the rate impacts associated with decoupling have been proven to be small, thereby undermining the risk-shifting argument; and (2) an opinion that most state regulatory commissions have not adopted ROE adjustments. NWEC cites a 2009 survey conducted by Pamela Lesh Morgan in support of its first assertion and an assessment by the Brattle Group as the supporting documentation for its second assertion.[18]

Q: Have adjustments to a utility's allowed rate of return from revenue neutrality proposals been recognized in other utility proceedings?

A: Yes. Exhibit No. DED-6 shows that a number of states, as well as the Federal Energy Regulatory Commission (FERC), have made adjustments to the allowed rate of return in recognition of the fact that revenue neutrality programs (decoupling and straight-fixed rate designs) change the risk profiles of regulated utilities. Some of these adjustments have actually been proposed by utilities, and

[18] Exhibit No. RCC-1T, p. 16.

in a number of cases, these adjustments have been adopted. Adjustments range from 6.5 to 50 basis points on a utility's allowed ROE. In Delaware, Delmarva Power and Light Company recommended an ROE reduction of 25 basis points as a risk correction for its proposed revenue decoupling mechanism. The proceeding settled and revenue neutrality proposals were withdrawn for later consideration in a generic docket.[19] Similarly, Chattanooga Gas in Tennessee recommended a 50 point basis reduction if both its proposed revenue decoupling mechanism and infrastructure replacement rider were approved. Again, the case was settled and the proposal for revenue decoupling was withdrawn.[20] In Vermont, Green Mountain Power agreed to a 50 basis point reduction and noted that its Alternative Regulation Plan "has the effect of shifting risk associated with varying power costs to ratepayers; in recognition of this risk shift, the Plan provides a lower return on equity."[21] In Maryland, the Maryland Public Service Commission (MPSC) recently upheld an existing 50 basis point ROE reduction for Baltimore Gas and Electric due to the Company's decoupling mechanism.[22]

/ /

/ / /

/ / / /

/ / / / /

[19] *In the Matter of the Application of Delmarva Power & Light Company* for a change in natural gas base rates (filed August 31, 2006), PSC Docket No. 06-284, Order No. 7152, March 20, 2007.
[20] *Petition of Chattanooga Gas Company*, for approval of adjustment of its rates and charges, comprehensive rate design proposal and revised tariff, Docket No. 06-00175, May 8, 2007.
[21] P*etition of Green Mountain Power Corporation for approval of an alternative-regulation plan,* Docket No. 7175; Docket No. 7176, Vermont Public Service Board, December 22, 2006, Order Entered.
[22] *In the Matter of the Application of Baltimore Gas and Electric Company for Revisions in its Electric and Gas Base Rates*, Case No. 9230, Order No. 83907, Maryland Public Service Commission, March 9, 2011.

In upholding this existing ROE reduction, the MPSC stated that:

> It is a truism that the higher the risk, the higher the potential return. BGE is a monopoly distribution-only utility with a risk-reducing mechanism….As such, it cannot have protection against revenue volatility without that protection being reflected in its return on equity.[23]

Q: Do you think the financial community recognizes the risk shifting nature of revenue neutrality mechanism?

A: Yes. Such risk shifting mechanisms can include, depending upon the state, the gas cost recovery clauses, weather normalization clauses, shorter weather normalization periods, pass-through recovery of LAUF (lost and unaccounted for) gas (for gas utilities), and uncollectibles expense. Revenue neutrality, in the form of revenue decoupling or straight fixed variable rate designs (for gas utilities), however, appears to be the most popular regulatory mechanism with many financial analysts.[24] Analysts see revenue neutrality mechanisms as being beneficial to shareholders by reducing overall risk.

Q: Do you have any examples?

A: Yes, Moody's Investor Service (Moody's), in a June 2005 Special Comment on natural gas utilities, noted:

> Moody's believes that having utility rate designs that compensate the gas LDC for variations in conservation as with variations in weather would serve to stabilize the utility's credit metrics and credit ratings.[25]

[23] *In the Matter of the Application of Baltimore Gas and Electric Company for Revisions in its Electric and Gas Base Rates*, Case No. 9230, Order No. 83907, Maryland Public Service Commission, March 9, 2011, p., 65.
[24] With the exception of support for Purchased Gas Adjustment (PGA) mechanisms for the few gas utilities which do not have them in place.
[25] "Special Comment: Impact of Conservation on Gas Margins and Financial Stability in the Gas LDC Sector," Moody's Investors Services, June, 2005: 8.

Further, Moody's indicated that revenue decoupling can impact the business risk categorization under which utilities are judged. This categorization, based upon business risk profiles, includes a measure for utilities that face supply and volumetric risk. Those with high risk are in the higher categories (highest risk category is 10), while those utilities that face lower risks by having adjustment clauses, are moved to lower levels. NW Natural, a gas distribution utility that has both a PGA and decoupling mechanism in Oregon, was able to lower its rank to 1, the lowest level risk category. Moody's subsequently reiterated the strong benefits revenue decoupling would provide in maintaining shareholder value. Since revenue decoupling eliminates shareholder exposure to risk and volatility from price and climate changes, such a mechanism will maintain strong credit metrics and improve credit ratings relative to utilities that do not have such mechanisms.[26]

Q: Please explain why NWEC's proposal for decoupling without a risk-shifting adjustment is not appropriate.

A: NWEC's decoupling proposal shifts a significant amount of risk to ratepayers. These risks include potential changes in price, the economy, weather, and other factors like greater economy-wide energy efficiency. However, under NWEC's current proposal, there is no corresponding offset in rates to compensate ratepayers for this shift. Failing to recognize the risk-shifting inherent in this mechanism results in rates that by definition are not fair, just, and reasonable and

[26] "Special Comment: Local Gas Distribution Companies: Update on Revenue Decoupling and Implications for Credit Ratings," Moody's Investor Services, June 2006.

allows the utility to obtain the very monopoly profits that regulation is intended to control.

Q: Are you recommending an ROE adjustment to NWEC's proposal?

A: No. In my opinion, an ROE adjustment is something that should be considered within the "context of a utility-specific rate case" as required by the Commission.[27] This is a requirement that the Commission stated must be met by any request for a full revenue decoupling mechanism,[28] and is likely one important reason why the Commission's Policy Statement envisions addressing full revenue decoupling proposals within "the context of a general rate case."[29] NWEC's proposal simply lacks a number of important real-world implementation details that are usually provided in the context of a rate case, such as the merits/demerits of an ROE adjustment, specific tariffs and tariff language associated with a decoupling mechanism, rate impact and backcasting analysis associated with implementing revenue decoupling, as examples.

D. Earnings Test.

Q: Does the NWEC proposal include an earnings test?

A: No. NWEC acknowledges the Commission's Policy Statement requires that any proposed revenue decoupling mechanism include a proposed earning test to be applied at the time of the true-up. However, NWEC excludes this important Commission requirement under the belief that full decoupling does not affect a

[27] *Policy Statement,* ¶ 28.
[28] *Id*.
[29] *Id*. While this docket originated as a full general rate case, that portion of the docket has now been fully concluded, with a settlement and new rates approved by the Commission. This proposal was brought forward subsequently. The settlement provides that if decoupling is adopted here, the issue of ROE would have to be revisited.

Company's natural incentive to control costs.[30] NWEC insists that an earnings test would only be applicable if the proposed mechanism was a partial decoupling mechanism where Avista could "pocket both 'found' and 'lost' revenues."[31] NWEC acknowledges no other legitimate concern for the Commission's request for proposals to include an earnings test.

Q: Do you agree with NWEC's position that an earnings test is not needed?

A: No. The omission of an earnings test could very easily lead to a situation where, under decoupling, and the purportedly reduced need for rate cases, a utility could be free to accumulate the very monopoly profits that regulation is intended to prevent. The ability to accumulate excess earnings is exacerbated by NWEC's decision to disregard "found margins" as an offset to revenue decoupling recovery balances (i.e., customer growth revenues, off-system sales).

E. <u>Risk and The Inclusion of Weather Related Adjustments</u>.

Q: Will the NWEC proposal make Avista whole for changes in weather-related sales?

A: Yes. NWEC has included the impacts of weather in its proposed revenue decoupling mechanism. Thus, under NWEC's revenue decoupling proposal, Avista will be made whole if weather is milder than normal and will be required to offer rebates if weather leads to greater than expected usage. While the Commission noted that it "generally support[s] including the effects of weather in a full decoupling proposal" it did not mandate the inclusion, as it did for other program components. Further, the spirit of the Commission's Policy Statement

[30] Exhibit No. RCC-1T, p. 11.
[31] *Id*.

would at least suggest that any program component that has the ability to shift risk away from a utility, and towards ratepayers, should be evaluated.

Q: Will the inclusion of a weather create price distortion and confusion for customers?

A: Yes. When weather is hotter than normal, and ratepayers use more electricity for cooling purposes than anticipated relative to the base year revenue requirement, these ratepayers (as a group) receive a line item credit a full year after their usage has changed. When ratepayers use less electricity than anticipated, they see a line-item surcharge at some point on their bills one year later.[32] From the individual ratepayer's perspective, there is no rhyme or reason to the endless yo-yo of surcharges and credits which can easily move in directions opposite to their individual usage patterns one year later. Ratepayers in any given month do not know if they will receive a credit or a surcharge because that determination is quite simply out of their control. This could not be classified as a reduction of risks to ratepayers, as rates become uncertain and more difficult to predict.

Q: Does the NWEC proposal make any risk-related adjustments associated with the inclusion of weather?

A: No. NWEC appears to believe that weather-related risks are symmetrical, and that weather risk overall is not a "zero sum enterprise."[33] Specifically, NWEC believes that inclusion of weather within the decoupling mechanism reduces risks for both customers and shareholders, as customers receive prompt relief from cost

[32] Exhibit No. RCC-1T, p. 8.
[33] Exhibit No. RCC-1T, p. 19.

increases driven by extreme weather events, and Avista shareholders likewise avoid failures to recovery of authorized fixed costs.[34]

Q: Do you agree with the premise that weather risk is symmetrical?

A: No. Any assertion that weather risk is symmetrical and that its inclusion in a revenue decoupling mechanism can serve as a balancing mechanism between customers and utilities is incorrect. While NWEC has made this assertion in its proposal, it has failed to provide any record evidence that proves such a relationship. NWEC appears to simply be making an unsupported argument that the inclusion of a weather-related true-up in revenues will effectively "institutionalize" long run weather trends: in some periods, rates will be increased due to warmer-than-normal temperatures and in other periods, rates will decrease to reflect colder-than-normal temperatures. Under this logic, in the long run, the colder-than-normal cycles will offset the warmer-than-normal cycles, resulting, on average, in a zero gain to either party (e.g., utility, ratepayers).

Q: Is the risk associated with weather-related sales changes typically symmetrical?

A: Usually not. The degree of asymmetry will in large part be a function of how the mechanism is constructed, the time period between rate cases, and the weather cycles under which the mechanisms are evaluated. It is quite possible that these mechanisms can be pure risk-shifting mechanisms placing greater weather-related sales risk on customers and away from utilities and their shareholders. Regardless, changing rates from a framework where utilities bear the risk of weather-related changes in sales to one where ratepayers bear this risk, clearly

[34] Exhibit No. RCC-1T, p. 19.

shifts risk away from the utility and towards ratepayers. Even if ratepayers were to receive a rebate for every year for a period of time, they have assumed the risk of uncertainty and lost the benefit of a fixed rate.

Q: Have any regulatory Commissions recognized the asymmetry of weather-related changes in revenue?

A: Yes. The Connecticut DPUC noted that weather related changes in revenues are not symmetrical in the benefits shared between the utility and ratepayer. In a recent Southern Connecticut Gas Company (Southern) decoupling proceeding, the utility noted that it has received significantly greater benefits than ratepayers over a 15 year period. The DPUC noted that "Southern received a total of $43.6 million in net WNA revenue" over a 15 year period and that the utility's "ROE has benefitted significantly."[35] Exhibit No. DED-7 provides a table, based upon data developed by Southern, that was cited by the DPUC as providing evidence regarding asymmetric WNA benefits accruing to the utility.

Q: What do economic principles suggest about the appropriate allocation of risk, such as weather, between two contracting parties?

A: Even if the risks (probability) were exactly symmetrical, the expected value of negative outcomes between the two parties (i.e., rate increases for ratepayers and decreased profits for utilities) are not. Utilities have a wider range of opportunities to diversify weather-related risk than ratepayers. Economic theory would suggest that, in this instance, the most efficient allocation of risk between

[35] *Application of the Southern Connecticut Gas Company for a Rate Increase. Connecticut Department of Public Utility Control,* Docket No. 08-12-07. Order Dated July 17, 2009. (Emphasis added)

these two parties (utilities and ratepayers) would be to apply that risk to the party with the best opportunities for diversification, which is typically the utility.

F. <u>True-Up Mechanism Deficiencies: Application To Customer Classes, Failure to Address Found Margins and Potential Gains From Off-System Sales</u>.

Q: Please describe the problems with the proposed NWEC true-up mechanism.

A: The specific mechanics of NWEC's proposed true-up mechanism are inconsistent with three general requirements established in the Commission's Policy Statement. The first is that the proposed NWEC mechanism applies to only residential and small commercial customers, rather than to all customer classes as required in the Commission's Policy Statement. The second is that the proposed NWEC mechanism fails to adequately address found margins associated with customer growth. The third is that the proposed NWEC revenue decoupling mechanism fails to address potential gains from off-system sales.

Q: Let's turn to the first true-up mechanism deficiency. Does NWEC's proposed revenue decoupling mechanism apply to all customer classes?

A: No, NWEC proposes to exclude the Extra Large General Schedule 25 class. NWEC's rational for excluding the Extra Large General Schedule 25 class is simply because the class has so few members (22) and accounts for a relatively small fraction of Avista's fixed cost revenue requirement.[36]

Q: Do you agree with NWEC's rational for excluding the extra large general Schedule 25 from a proposed decoupling mechanism?

A: No. Avista offers energy efficiency measures to many different customer classes,

[36]Exhibit No. RCC-1T, p. 10.

including non-residential customer classes. Included within Avista's offerings are non-residential programs that potentially include customers excluded in the NWEC revenue decoupling proposal. These large customer energy efficiency programs include incentives for premium efficiency motors, as well as site-specific measures.[37] NWEC's proposal to exclude these customers from its revenue decoupling mechanism is illogical if the goal of the mechanism is truly to remove a utility's so-called throughput incentive.

Q: Let's turn to the second true-up mechanism deficiency. Does the NWEC proposal accurately account for customer-related revenue growth?

A: No. NWEC's proposed mechanism contains no corrective factor for revenues obtained from "found margins" resulting from an increase in Avista's customer base. NWEC argues that a corrective factor for an increased customer base is only needed if a utility's growth in customer counts typically outstrips growth in overall retail sales. In support of this argument, NWEC presents an analysis that purports to show that between 2000 and 2010, Avista's electricity sales grew by 11.5 percent, while the company's customer counts increased by 12 percent.[38]

Q: Do you agree with NWEC's argument against the inclusion of a corrective mechanism for "found margins" resulting from an increase in Avista's customer base?

A: No. Exhibit No. DED-8 shows Avista's sales and usage per customer for each of the utility's three largest rate classes (residential, general service, and large

[37] Avista Response to Public Counsel Data Request No. 140, Attachment A, 2011 DSM Business Plan, 28-29.
[38] Exhibit No. RCC-1T, pp. 8-9.

general service) for the years 1991 through 2010. As can be seen in this exhibit, the vast majority of Avista's increased sales have not been due to increases in per customer usage, as suggested by NWEC, but by an increase in the utility's customer base. Inclusion of a corrective mechanism for "found margins" resulting from a growth in Avista's customer base is important and consistent with the Commission's Policy Statement.

Q: Should customer growth-related revenues be used as "found margins" to apply against the "lost margins" associated with Avista's energy efficiency activities?

A: Yes. The Commission noted in its Policy Statement that limited decoupling mechanisms should contain offsets from increased margins due to a growing customer base and stated that: "If these [decoupling] revenues and costs are not in reasonable balance, we would consider excluding all or some new customer revenue from the mechanism or some other tool *(e.g.*. modifying a utility's line extension tariffs) to correct any demonstrated inequity."[39] Indeed it was for this very reason the Commission stated it did not believe limited decoupling mechanisms were appropriate for electric utilities, precisely because growth in per-customer usage mitigated any potential adverse impact from conservation efforts.[40]

Q: Let's turn to the third true-up mechanism deficiency. Does the NWEC proposal accurately account for off-system sales growth?

[39] *Policy Statement,* ¶ 28 n.44.
[40] *Id.*, ¶ 20.

A: No. NWEC did not account for off-system sales growth in its proposed mechanism as NWEC believes Avista's Energy Recovery Mechanism (ERM) already responds to this concern. NWEC admitted however that the ERM includes a deadband wherein wholesale transactions to a certain price level are not included within the ERM.[41]

Q: Has Avista recognized that off-system sales could be attained through its energy efficiency efforts?

A: Yes. In the current case, Avista originally proposed an Energy Efficiency Load Adjustment (EELA) to adjust test year net operating income for an expected reduction due to its energy efficiency programs. This mechanism attempted to directly address off-system sales by including a base revenue credit of some $3.0 million.[42] Under this proposal, the Company recognized, consistent with Commission direction, that its energy efficiency efforts result in off-system sales opportunities, and that these opportunities should be included as an element of any proposed decoupling mechanism. By contrast, NWEC's summary dismissal of potential off-system sales benefits provides further evidence of how its approach is inconsistent with the Commission's Policy Statement.

G. <u>Lack of Incremental Conservation Achievement</u>.

Q: Is the NWEC revenue decoupling proposal based upon any incremental savings estimates?

A: No. NWEC has not satisfied the Commission Policy Statement request for

[41] Exhibit No. RCC-1T, pp. 12-13.
[42] Direct Testimony of Patrick D. Ehrbar, Exhibit No. PDE-T, p. 47, Table 18. The total (net) EELA adjustment was $2.67 million for two full years of energy efficiency savings.

"evidence describing any incremental conservation that [Avista] intends to pursue in conjunction" with its proposed revenue decoupling mechanism.[43] NWEC's proposal fails to offer any new, incremental energy efficiency savings that will be created as a consequence of their new regulatory proposal.

H. <u>Failure to Address Low Income Issues</u>.

Q: Does the NWEC revenue decoupling proposal adequately address low-income customer issues?

A: No, NWEC does not address low-income customer rate impacts within its decoupling proposal, commenting that "if any party to this proceeding thinks low-income customers are paying too high a share of Avista's costs of service, decoupling does not add to the problem."[44]

Q: Do you agree with NWEC's assertions regarding the rate impacts associated with revenue decoupling?

A: No. NWEC cites a study authored by Pamela (Lesh) Morgan as being an authoritative study on the impacts of revenue decoupling. The study (hereafter "Morgan Report"), however, is flawed and is based upon a number of estimates and assumptions that, by its own admission, are limiting. For instance, the study notes in the introduction that its purpose was to "compile the rate impact experience during this decade with decoupling of retail gas and electric utility

[43] *Policy Statement,* ¶ 28.
[44] Exhibit No. RCC 1-T, 14.

revenues from sales volumes"[45] by a "comparison of the decoupling adjustment to the total rate at or near the time of the adjustment."[46] Later, however, the Morgan Report notes its own limitations:

> *It was much more difficult to find a total retail rate for the rate classes covered by the decoupling mechanism and, thus, to calculate the size of the decoupling adjustment as a percentage of the total rate*. This was particularly problematic where the adjustments were for prior years or the commodity portion of the rate changed frequently, as is common for gas utilities and restructured electric utilities. In many cases, this report uses average annual (or monthly for 2009) retail gas electric price information for the appropriate state found on the EIA website. *The goal was to provide context* for the decoupling adjustment, <u>not</u> *state precise percentages* and the EIA data served well for the purpose.[47]

Q: Does the Morgan Report support the assertion that revenue decoupling creates minimal rate impacts?

A: No. Exhibit No. DED-9 provides a summary of the results provided in the Morgan Report. The table provides the number of instances in which there were observed rate increases or rate decreases for electric and gas utilities under revenue decoupling. The table shows 72 percent of the gas utilities and 57 percent of all the electric utilities in the sample had reconciliations resulting in rate increases instead of rate decreases over the past decade. This starkly contradicts any assertion that decoupling will yield results that are symmetrical. Furthermore, 18 percent of all gas decoupling surcharges were of an amount greater than three percent. On the other hand, all reconciliations resulting in

[45] Pamela G. Lesh. *Rate Impacts and Key Design Elements of Gas and Electric Utility Decoupling: A Comprehensive Review*. June 30, 2009: 1. (Emphasis added).
[46] *Id*., p. 4.
[47] *Id*., p. 8.

refunds greater than three percent were themselves a mere three percent of all reconciliations: a 6-to-1 ratio of extreme rate increases to extreme rate decreases. Such a finding suggests an outcome highly skewed against ratepayers.

Q: Do these generic findings mask some other extreme observations about the rate impacts associated with past decoupling experience?

A: Yes. There are a number of noticeably extreme rate increases created by revenue decoupling that have been highlighted in the study, assuming its representations are accurate. Consider for instance, the decoupling adjustments reported for Pacific Gas and Electric (PG&E). Decoupling-induced surcharges (positive deferrals) increased from a level of $24.64 million to $148.9 million (504 percent) between 2006 and 2007. Likewise, surcharges increased from $11.4 million to $103.55 (or 808 percent) 2008 to 2009. Over the time period presented in the table, PG&E ratepayers saw an average decoupling surcharge every year of $77.6 million.

Q: Does this study address the most important issue with decoupling?

A: No. It still fails to ask and answer a more important policy question: are revenue decoupling recoveries more than offsetting lost base revenues that arise from a utility's energy efficiency efforts? If the empirical findings from this question are affirmative, then it raises significant questions about the regulatory efficacy of revenue decoupling and its overall sustainability (in an unmodified/uncorrected fashion) regardless of whether or not the recoveries are small or large. Allowing the ratemaking process to produce monopoly rents should come be an unacceptable outcome for any regulator.

Q: Are there flaws in the LBNL study that NWEC relies upon to assert that revenue decoupling is likely to lead to less volatile rates?

A: The LBNL study,[48] published in the mid-1990s, has a number of limitations. First, the study's empirical findings are based upon a dataset of vertically-integrated electric utilities during a period of 1964 to 1988: a period that predates virtually every major regulatory change over the past twenty years in the structure of electricity markets. The study also uses a cost methodology (in examining the relationship between costs, revenues, and volumes) that has virtually no support in the academic literature of production cost modeling and suffers from so many statistical shortcomings that it is virtually useless in assisting the Commission in reaching any empirical conclusions about the role of costs, revenues, and revenue decoupling. For instance, the R-square values (the predictive values) for the regressions included in the research range from a low of 0.07 to a high of 0.17. Lastly, the study's conclusions about risk and volatility are based upon a hypothetical and not observed data. The Commission should place no weight on these study findings.

Q: Does the NWEC revenue decoupling proposal provide any adequate ratepayer protections?

A: No. The NWEC revenue decoupling is devoid of any meaningful ratepayer protection mechanisms. Capping deferrals to three percent of total revenues is the only component of NWEC's proposal that could be claimed as a ratepayer protection: yet, even this proposal is inadequate. Failure to include a range of

[48] J. Eto, S. Stoft, and T. Belden. (1994) *The Theory and Practice of Decoupling*. Berkeley, CA: Lawrence Berkeley National Laboratory, p. 32.

important ratepayer protection mechanisms represents another area where the NWEC proposal is inconsistent with the specifics and spirit of the Commission's Policy Statement.

Q: Why is NWEC's proposed three percent cap inadequate?

A: It is inadequate for three reasons. First, the cap is well above what is used in other states for revenue decoupling purposes. A table outlining ratepayer protection components adopted by other state commissions has been provided in Exhibit No. DED-10. Second, the revenues associated with NWEC's proposed cap are very large. Three percent of Avista's annual total revenues is $13.6 million.[49] Further, NWEC's proposal is capped to total revenues, not fixed costs (or base) revenues, meaning that if fossil fuel and wholesale power prices were to increase, the absolute dollars associated with this cap would increase commensurately. Third, the cap is disproportionate to the maximum exposure Avista could face through its energy efficiency efforts, particularly those set by its legislative goals. As previously discussed, the estimated lost base revenues associated with the Company's energy efficiency activities are not likely to exceed $2 million over the next two years:[50] an amount that is a fraction of the size of the cap proposed by NWEC.

Q: Have any other states adopted ratepayer protection mechanisms as part of their decoupling mechanisms?

A: Yes, several states have adopted ratepayer protection mechanisms as part of their

[49] Avista's Response to NWEC Data Request No. 005. Avista's annual rate revenues are listed as $453 million.
[50] This number reflects the average lost base revenues for 2012-2013 as presented in Exhibit No. DED-5.

revenue decoupling programs including Oregon, Utah, and Colorado, to name a few. As I noted earlier, Exhibit No. DED-10 provides a table of utilities with active revenue decoupling mechanisms in place and identifies their ratepayer protections.

V. CONCLUSIONS AND RECOMMENDATIONS

Q: Can you please summarize your recommendations regarding NWEC's revenue decoupling proposal?

A: Yes. I recommend that NWEC's proposed revenue decoupling mechanism be rejected for the following reasons:

- The proposal is based upon an incorrect premise that is contrary to state law and fundamental regulatory principles.
- The proposed mechanism would shift revenue recovery risk associated with changes in the economy, price, and other factors away from the Company and its shareholders and onto ratepayers. Such a shifting of risk, without any corresponding mitigation measure, will result in rates that are not fair, just, and reasonable.
- The NWEC proposal fails to address the multiple issues and requirements raised in the Commission's Policy Statement

Q: Can you please review the reasons why NWEC's proposal fails to address the requirements for revenue decoupling outlined in the Commission's Policy Statement?

A: Yes. The NWEC proposal fails to adequately address a number of full decoupling policy preferences that were clearly enumerated in the Commission's Policy Statement including:

- The proposed mechanism does not condition revenue decoupling recoveries on Avista's energy efficiency performance.
- The proposed mechanism fails to address the Commission's concerns that revenue decoupling, while addressing an asserted conservation disincentive for utilities, could create other significant undesirable incentives and outcomes such as risk shifting and inefficiency, contrary to fundamental regulatory policy.
- The proposed NWEC mechanism fails to include any evaluation or adjustment for the risk-shifting nature of revenue decoupling.
- The proposed NWEC mechanism rejects the use of an earnings test.
- The proposed NWEC mechanism does not adequately address the risk shifting nature of its inclusion of weather-related changes in revenue.
- The true-up mechanism associated with the proposal:
  - Is limited to a select group of customers.
  - Fails to adequately account for "found revenue margins" associated with customer growth.
  - Fails to adequately account for gains from off-system sales.
- The proposed NWEC mechanism is not tied to any incremental energy efficiency savings that would arise from the mechanism's implementation, nor does it provide any evidence that such savings would occur.

- The proposed NWEC mechanism does not adequately address the potential impact of revenue decoupling on low-income households.
- The mechanism does not include adequate ratepayer protection provisions.

Q: Does this conclude your testimony?

A: Yes.