Exhibit No. ___(PDE-9T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-110876

DOCKET NO. UG-110877

DIRECT TESTIMONY OF

PATRICK D. EHRBAR

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

A. My name is Patrick D. Ehrbar and my business address is 1411 East Mission Avenue, Spokane, Washington. I am presently assigned to the State and Federal Regulation Department as Manager, Rates and Tariffs.

Q. Have you previously provided direct testimony in this Case?

A. Yes. My testimony in Dockets UE-110876 and UG-110877 addressed, among other things, the Company's proposed rate spread and rate design related to its electric and natural gas revenue increase requests.

Q. Are you sponsoring any Exhibits with this testimony?

A. Yes. I am sponsoring Exhibit No.___(PDE-10) which will be explained later in my testimony. This exhibit was prepared under my supervision.

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

A. The purpose of my testimony is to provide the Company's response to the testimony of Mr. Ralph Cavanagh on behalf of the Northwest Energy Coalition ("NWEC"), as it relates to their proposed electric decoupling mechanism. In summary, Avista is not requesting an electric decoupling mechanism at this time, nor did it request one in its original filing. However, should the Commission order an electric decoupling mechanism, such a mechanism should factor in all changes in use per customer, including changes due to weather. In addition, I will explain that, because decoupling would remove the opportunity for revenues to grow following the test year through growth in use-per-customer, it would undermine the matching principle inherent in historical test-period

ratemaking. Therefore, if decoupling is adopted, it should be done with the intention of also adopting additional adjustments in the general rate case process to provide the utility with the opportunity to recover its costs and earn the allowed return.

A decoupling mechanism should be simple for customers to understand and for the Company, the Commission Staff, and other parties to implement, and should not require any reduction to the Company's allowed return on equity or modification to the Company's equity layer in its capital structure. Moreover, any decoupling mechanism ordered by the Commission should be implemented in the Company's next general rate filing.

Q. Did the Company propose an electric decoupling mechanism in its original filing?

A. No, the Company did not propose an electric decoupling mechanism. Rather, the Company proposed an Energy Efficiency Load Adjustment ("EELA") which restated the weather-normalized test year loads of the Company's retail electric customers to reflect the impact of the Company's programmatic electric energy efficiency efforts following the test year. The purpose of that adjustment was to directly address the reduction of retail revenues associated with Company-sponsored conservation that occurs following the test year, and through the 2012 rate year when new retail rates would be in effect.

Q. Was the proposed EELA accepted as a part of the Settlement Stipulation filed in this docket?

A. No. As noted in the Settlement Stipulation approved by the Commission in Order No. 06 in Dockets UE-110876 & UG-110877 ("Settlement Stipulation"), the

Settling Parties stated that the "Parties did not agree to the EELA, and it was removed from the revenue requirement, and the billing determinants were adjusted to remove the EELA, in this Settlement Stipulation".[1] Although it will be discussed briefly later in my testimony for purposes of describing the lost margin issue, Avista is not renewing its request for an EELA as part of this docket.

Q. Is the Company now proposing an electric decoupling mechanism?

A. No, as I stated earlier, the Company is not requesting an electric decoupling mechanism. However, as noted in the Settlement Stipulation, the Settling Parties agreed that should "the Commission conclude that further proceedings in Docket No. UE-110876 should be conducted for purposes of addressing any electric decoupling proposal by the Coalition, the Settling Parties reserve the right to contest such proposals or provide alternative proposals".[2] Avista provides, in the testimony that follows, recommended modifications to the electric decoupling mechanism proposed by the NWEC, if the Commission were to approve a decoupling mechanism.

Q. If the Commission were to approve such a mechanism, when would the Company prefer it to be implemented?

A. The Company would prefer that such a mechanism go into effect at the conclusion of the Company's next general rate case. The Company plans to file a general rate case in the first half of 2012. In that case all parties would have the opportunity to weigh-in on the appropriate "base numbers" to use in the deferral calculations going forward, as well as any other implementation details associated with the new mechanism.

Q. How is your testimony presented in this matter?

[1] Settlement Stipulation, ¶ 6(c).
[2] Settlement Stipulation, ¶ 16 (footnote 8).

A. First, I will provide an overview of Avista's perspective on a decoupling mechanism. Next, I will discuss the elements and mechanics of an appropriate decoupling mechanism should the Commission choose to approve one. Finally, I will address how the mechanism would satisfy the Commission's "Criteria for Approval" of the mechanism provided for in the Commission's "Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, To Encourage Utilities To Meet Or Exceed Their Conservation Targets".[3]

OVERVIEW OF AVISTA'S PERSPECTIVE ON DECOUPLING

Q. Please summarize Avista's views on electric decoupling.

A. Avista would support an electric decoupling mechanism if it were designed and implemented in a way that truly "fixes" the problem that caused a decoupling-type mechanism to be proposed in the first place. Here is the problem: rates are established in a general rate case to provide revenue to recover the costs to provide service to customers. The majority of that revenue is received on a volumetric basis, i.e., based on the volume of kilowatt-hour (kWh) sales. At the same time, Avista is obligated by law to pay its customers to use fewer kWhs through the implementation of energy efficiency measures, and, if unsuccessful, would incur stiff penalties.

After new retail rates are established in a rate case, all other things being equal, Avista's customers will, in fact, consume a lower volume of kWh than that included in designing the rates, and therefore revenues will not be sufficient to cover Avista's costs. Because the current ratemaking process does not account for the known reduction in kWh sales related to energy efficiency, rates set based on historical test period loads are actually

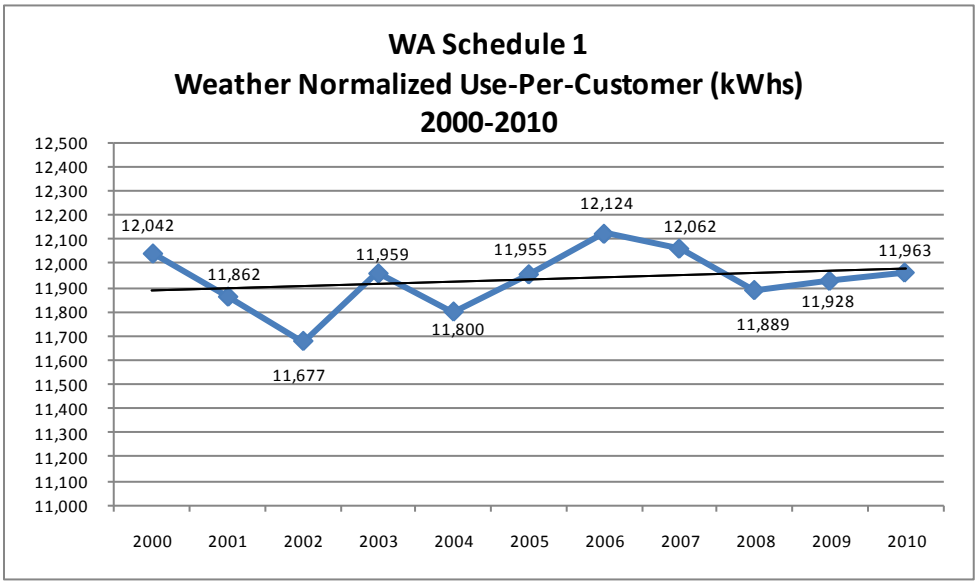
[3] Docket U-100522

designed to not provide recovery of the Company's costs under normal operating conditions.

Some stakeholders will argue that Avista will hook up new customers that will provide additional revenues. This is true. But those new customers create new generation, transmission and distribution costs that offset a major portion of those additional revenues. Furthermore, the use of historical test-year ratemaking presumes that there will be growth in retail revenues following the test year to help offset the growth in costs that will also occur following the test year.

Some will also argue that use-per-customer may increase between rate cases as customers, for example, plug in more electronic devices. However, as Chart 1 below shows, our residential use-per-customer, on a weather-normalized basis, has remained relatively flat over the last 10 years.

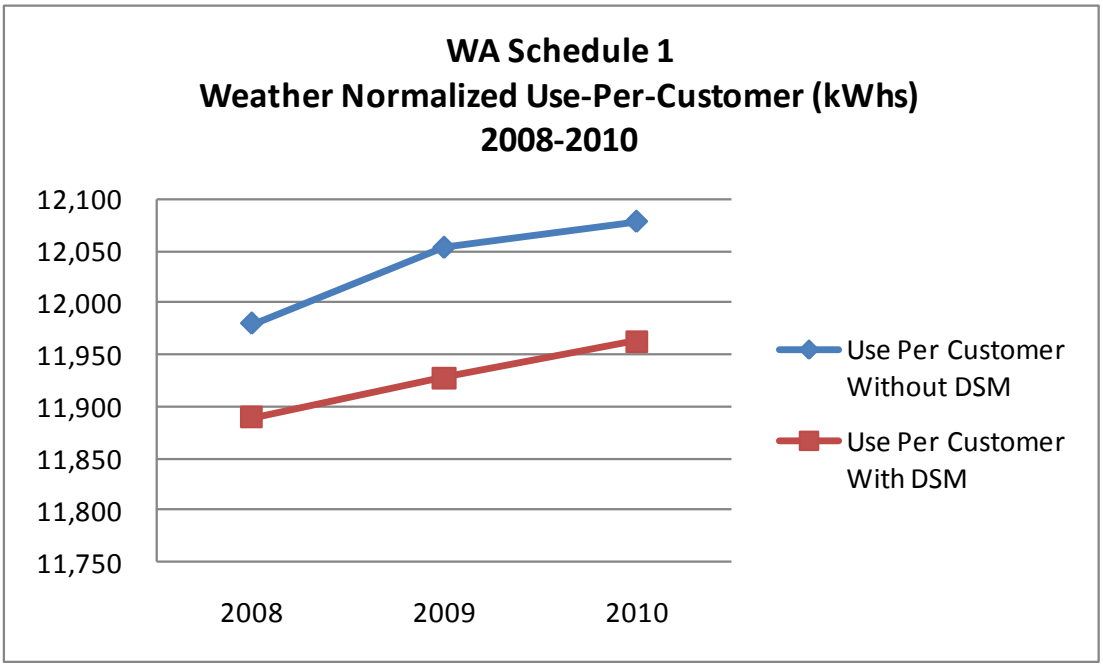
Chart 1 – Schedule 1 Weather-Normalized Use-Per-Customer for 2000 - 2010



A major part of why use-per-customer has remained relatively flat is due to our success in paying customers, through our energy efficiency programs, to conserve energy

and use less of our product. We would recover more of our costs to provide service without our energy efficiency efforts, as shown in Chart 2:

Chart 2 – Schedule 1 Weather-Normalized Use-Per-Customer for 2008 – 2010 before and after DSM Savings



Some parties have also made the argument that, if use-per-customer is remaining flat or growing in the face of energy efficient measures, then there is no need for decoupling or some other mechanism to provide recovery of lost margin. On the surface this argument makes sense. However, with the ratemaking practices employed in Washington, it is simply not true.

Q. Please explain.

A. The explanation is very straightforward. Washington uses a historical test period for ratemaking, with limited pro forma adjustments for the future rate year. Under this approach to ratemaking, the presumption is that revenues will grow from the historical test year to the future rate year to cover a portion of the increased expenses and increased

investment that will occur between the two periods. The only way this type of ratemaking works is to provide the opportunity for revenues to grow following the test year. It is understood that there will be some uncertainty regarding the extent to which revenues will grow and how much expenses and investment will grow following the test year, and it is incumbent on the utility to manage these changes.

However, if there is a known change in revenues following the test year, it should be reflected in the ratemaking process. Otherwise you start from "day one," after new rates are set, knowing that you will not receive the amount of revenue the rates were designed to recover because the kWh sales to existing customers following the test year will be less. Energy efficiency is a known change following the test year. We are required by law to do it. Savings are well documented. It is a certainty that we will achieve kWh savings and they will be verified by an independent third-party. The ratemaking process in the state of Washington includes retail kWh sales in designing rates that we know will simply not occur, which results in a short-fall in cost recovery. Achieving energy efficiency kWh savings takes away the growth in revenue that is needed to cover growth in costs under a historical test year ratemaking process.

To the extent there is any growth in net revenue from new customers, or through growth in use-per-customer, if that revenue is captured to offset the known reduction in revenue from energy efficiency savings, it would undermine the use of historical test-year ratemaking, since those revenues would not be available to offset the growth in utility costs following the test year.

Unless some kind of adjustment is included in a general rate case for the planned energy efficiency, such as the Energy Efficiency Load Adjustment originally proposed by

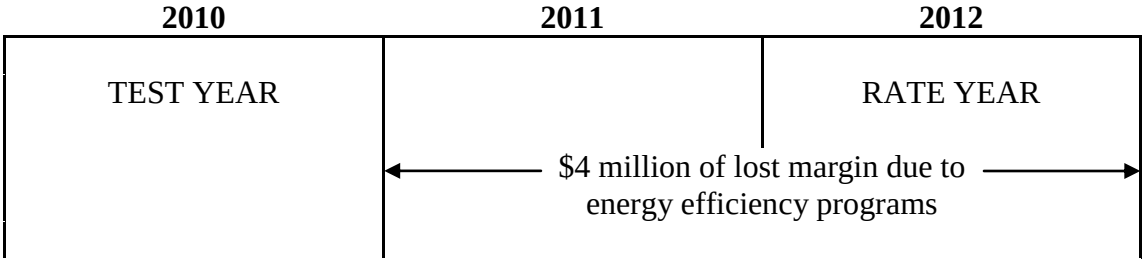
the Company in this docket, or there is some form of mechanism after the fact, such as decoupling plus other rate case adjustments, or deferred accounting, that restores the revenue related to energy efficiency kWh savings, the historical test year form of ratemaking used in the state of Washington fails to provide sufficient cost recovery. It does not provide a reasonable opportunity to earn the authorized rate of return. This shortfall in revenues is one of the reasons why Avista continues to earn well below their allowed return on investment.

Q. What is the order of magnitude of the reduction of revenues, or cost recovery, caused by energy efficiency for Avista?

A. During the 2010/2011 biennial period Avista's targeted energy savings were 129 million KWH for the two-year period. Using a lost-margin rate of approximately three cents per KWH, for illustrative purposes, to derive an order of magnitude number, the two-year reduction in net revenue, or lost margin, is approximately $4 million. In a general rate case, where a historical test period is used to establish rates for a future rate year, there are two-years from the test year to the rate year, therefore the shortfall in revenue in the ratemaking process related to energy efficiency would be for a two-year period, as shown in Illustration #1 below:

Illustration #1:

TIMELINE



As a point of reference, Avista's proposed Energy Efficiency Load Adjustment in its recent general rate case was $4 million, which was intended to replace the revenue that we knew would be lost following the historical test year because of our ongoing energy efficiency programs.

Q. What is the Company's view on proposals to reduce the allowed return on equity (ROE) or adjust the equity layer in the Company's capital structure in the event the Commission were to adopt decoupling or some other adjustment the replace the lost revenue related to energy efficiency?

A. Such proposals are without merit. The only reason we are considering decoupling in the first place is there is recognition that energy efficiency kWh savings eliminates revenue from the utility intended to cover utility costs. That is, the ratemaking process assumes the revenues are there, but because kWh sales are eliminated through the energy efficiency programs after retail rates are set, the revenues actually do not occur. So decoupling represents a "fix" or "patch" to the ratemaking process to restore the revenue related to energy efficiency. The revenue provided to Avista through a decoupling mechanism would <u>not</u> represent additional revenue to the Company over and above what is needed to recover its costs; it represents <u>restoration</u> of revenues that the Commission has already determined should be provided to the utility from the last rate case. Therefore, it does not represent reduced risk to the utility or a shift of risk from the utility to its customers; it is a replacement of revenue that the ratemaking process assumes is present, when in fact the revenue is not realized because of energy efficiency.

If ROE were to be reduced with the adoption of decoupling, we would end up at the same place. We would potentially add revenues back with decoupling, but then take

revenue away with an ROE/equity layer adjustment. For illustrative purposes, Avista's electric rate base in Washington is approximately $1.1 billion, of which approximately 49% is supported by equity. If the Commission were to reduce ROE by even 25 basis points with the adoption of decoupling, the reduction to Avista's revenues, and therefore its earnings, would be approximately equal to the revenues assumed to be gained through decoupling. The lost margin in the ratemaking process from energy efficiency is approximately $4 million, and the reduced earnings to Avista from a 25 basis point reduction to ROE over the same two-year ratemaking period, is also $4 million.[4] An ROE adjustment would put us in the same place; our earnings would be lower as a result of engaging in energy efficiency.

Q. If decoupling were to be adopted in the state of Washington, would it fully restore the revenue that the Company would otherwise receive absent energy efficiency?

A. No. Even if decoupling is adopted, even without an ROE reduction, the Company would still be worse off by engaging in energy efficiency efforts, than if it did not promote energy efficiency. In short, with historical test year ratemaking, decoupling will not remove the disincentive utilities face with the promotion of energy efficiency.

Q. Why?

A. As I mentioned earlier, the historical test year ratemaking process employed in Washington presumes that revenues grow from the test year to the future rate year to cover a portion of the increase in expenses and investment from the historical test-year to the future rate year. With the implementation of decoupling, although it would restore

[4] $1.1 billion x 49% equity x 0.25% ROE divided by 0.65 (1 – the FIT rate) x two years.

revenue related to a reduction in use-per-customer, it would also take away, or rebate back to customers, any increase in revenues related to an increase in use-per-customer that may occur. Furthermore, if not designed properly, the mechanism could also rebate revenues to customers associated with growth in the number of customers, which would also undermine the historical test-year ratemaking process.

Therefore, with decoupling, the opportunity for the increased costs from the test year to the rate year to be covered by increased revenues is essentially taken away, i.e., decoupling would take away increased revenues that are intended to cover increased costs, under a historical test year ratemaking process such at that employed in Washington.

Thus, if the Commission were to adopt decoupling, even without a reduction to ROE, Avista would still be worse off from promoting energy efficiency.

Q. In your view, what is the most effective way to address the restoration of revenue related to energy efficiency?

A. There are two methods that are simple and straightforward, and are consistent with the use of historical test year ratemaking. The first is the use of a pro forma adjustment in a general rate case similar to the Energy Efficiency Load Adjustment proposed by Avista in our recent rate case. (This adjustment was eliminated as part of the Settlement of that docket, and even though it is discussed herein for purposes of explaining the problem, Avista is not proposing such an adjustment in this proceeding.) The adjustment was based directly on the required energy efficiency kWh savings from the test year to the rate year, and was designed to restore the revenue that we know will not be there in the future because of the energy efficiency efforts. Any other changes to retail kWh sales following the test year, whether caused by weather, plug load, the economy or

any other factors will be whatever it turns out to be, and the utility would continue to be at risk for all of those unpredictable changes.

The presumption, as stated before with the use of historical test year ratemaking, is that the loads and revenues will grow following the test year to cover a portion of the increase in expenses and investment from the test year to the rate year. The EELA would have directly removed the impact that the energy efficiency programs have on margin to the Company, and all other utility revenues, expenses and investment would function just like they otherwise would absent the energy efficiency programs, both within the general rate case and following the general rate case.

The second simple approach would be to use deferred accounting, after the fact, to quantify the lost margin related to the energy efficiency programs, and recover it through a later rate adjustment. After the energy efficiency savings are independently verified each year, the lost margin can be easily calculated and deferred for later recovery. Again, as with the EELA described above, this deferred accounting approach targets only the lost margin related to the energy efficiency programs, and the Company is at risk for any other changes in retail loads following the historical test year.

Unlike a decoupling mechanism, these two approaches do not take away the growth in retail loads and revenues which, under historical test year ratemaking, is necessary to cover a portion of the changes in costs following the test year. These two approaches work in harmony with historical test year ratemaking.

Q. In your view, what is the most straightforward way for the Company to recover its fixed costs?

A. The rates established in a general rate proceeding are intended to provide the opportunity for full recovery of the costs of providing service to customers. When the majority of fixed costs are recovered through sales volumes, and sales volumes are lower than expected, the recovery of fixed costs falls short of the level authorized by the Commission. Therefore, from a pure cost recovery standpoint, the fixed costs of providing service would be recovered through a fixed monthly charge, paid by each customer irrespective of actual usage. The rationale for that type of rate design is that a utility's facilities and support functions are made available to its customers irrespective of how much energy they use. As shown in NWEC witness Cavanagh's Exhibit No. ___(RCC_3), for Schedule 1 in particular, approximately $129 million out of $144 million in fixed costs in the Company's original filing are designed to be recovered in the variable energy rate.

If the Company had a rate design which allowed for the full recovery of fixed costs in the fixed monthly charge, that fixed charge for residential Schedule 1 would need to be approximately $49.37 per month[5] in order for the utility to recover its fixed costs of providing service. However, many utility commissions have rejected this straight-fixed variable rate design, because, among other things, some believe it may not send an appropriate conservation price signal as the variable energy rate would be lower.

[5] Exhibit No. ____(PDE-10), Page 2 ($43.37 FCC + $6.00 Basic Charge).

ELEMENTS OF THE ELECTRIC DECOUPLING MECHANISM

Q. If the Commission were to approve a decoupling mechanism in this Docket, please explain any modifications that Avista would recommend be made to the mechanism proposed by the NWEC.

A. The NWEC proposed "a straightforward form of per-customer decoupling based on the fixed-cost per-customer revenue requirement adopted for each rate class in this proceeding, with annual reconciliations of actual to authorized fixed cost recovery and subsequent rate true-ups for all participating customer classes."[6] Avista agrees that this conceptual form of decoupling is preferable, for reasons which will be discussed later in my testimony.

That being said, the NWEC did not provide specific details and examples in their testimony of how this proposed mechanism would work. It is our understanding that the NWEC proposal was patterned after the existing decoupling mechanism for Idaho Power in the State of Idaho. Again, while the Company has not requested an electric decoupling mechanism, if the Commission does approve a mechanism, Avista proposes that the Commission approve the specific mechanics of the mechanism as described below.

Decoupling Deferral = (CUST * FCC) – (Usage * FCER)

- CUST = Number of Customers in the current period
- FCC = Fixed Cost per Customer as determined in a general rate case
- Usage = Actual usage in the current period (no weather normalization)
- FCER = Fixed Cost Energy Rate per kWh as determined in a general rate case

Q. The first variable in the Decoupling Deferral equation is "CUST" which represents the number of customers in the current period. How would monthly customer counts be determined?

[6] Direct Testimony of Ralph Cavanagh, Page 8, ll. 9-12

A. Each month, the Company would determine the actual number of active service points (customers) for each applicable rate schedule. This count of meters billed is the same information that is used in determining customer counts for FERC Form 1 reporting requirements, and would be consistent with the method used in a general rate case to quantify the number of customers.

Q. The second variable in the equation is "FCC", or Fixed Cost per Customer. What is the FCC and what are the steps required to calculate the FCC?

A. The Fixed Cost per Customer component is simply the calculation of total fixed costs divided by the number of customers in the test period. While most fixed costs are recovered in the variable energy rate, some fixed costs are recovered in basic/fixed charges, so those costs need to be removed in the calculation. The determination of the total fixed costs require the following calculation for each rate schedule, which is detailed on Page 1 of Exhibit No. ___(PDE-10):

1. Determine the Total Rate Schedule Revenue
2. Remove Basic Charge Revenue
3. Remove Revenue Related Expenses such as Commission Fees.
4. Remove energy classified Production/Transmission Costs, calculated by taking the total normalized kWh usage, by rate schedule, multiplied by the rate schedule's specific modified Retail Revenue Credit[7].
5. The resulting figure is the Total Fixed Costs Recovered in the Volumetric Rate.

[7] The Retail Revenue Credit rate is currently based on a revenue requirement calculation of the fixed and variable production and transmission costs authorized in the Company's last rate case. The net costs include production and transmission related sales for resale and other revenues, operating expenses, maintenance expenses, purchased power expenses, depreciation and amortization expenses, and a return on production and transmission rate base including federal income tax. The Company is proposing a modified retail revenue credit rate for this mechanism which would be determined based on the energy classified portion of the fixed and variable production and transmission revenue requirement identified above, as established in the Company's cost of service study from the general rate case.

The RRC is calculated in the revenue requirements model on a jurisdictional total basis, and does not include any administrative and general or revenue related expenses. In order to identify the RRC amounts within each rate schedule, the Functional Component Summary from the Cost of Service Exhibit is used, and is adjusted to exclude both administrative & general as well as revenue related expense assignments to the production and transmission functional costs.

Once the level of fixed costs included in the volumetric rate has been calculated, the next step is to divide that figure by the number of customers in the test period. In this case, the Company used 2010 test year average customers. Dividing the class fixed costs by the number of customers results in the Fixed Cost per Customer, as shown on Pages 2 through 4 of Exhibit No.___(PDE-10).

Q. What is the importance of the FCC?

A. The FCC calculation sets the level of fixed cost recovery, on a per customer basis. That amount, which is currently $43.37 per month for residential customers as shown in Exhibit No. ___(PDE-10), Page 2, is the amount of fixed costs that the Company should recover from its residential customers on a monthly basis through the volumetric rate (excluding the basic charge). Taking the $43.37 per month, multiplied by twelve months, and then multiplied by the actual number of customers in the rate year, will set the actual fixed cost recovery level. If the Company experiences customer growth, then it is assumed that those new customers will be no different than existing customers in that each customer should contribute $43.37 per month, on average, through their volumetric rate.

Q. Earlier in your testimony you stated that the mechanism would utilize a retail revenue credit by rate schedule as opposed to the system retail revenue credit. Why is this an important component of the FCC calculation?

A. The Washington system modified retail revenue credit represents average energy classified production and transmission costs embedded in the allowed revenue requirement. Because the proportion of costs attributable to production/transmission varies by rate schedule, the amount of energy classified production/transmission costs in an individual rate schedule will be higher or lower than the Washington system average. For

example, if the Company subtracted the Washington modified system average retail revenue credit in the FCC calculation versus the modified Schedule 1 retail revenue credit (which is lower than the Washington system average retail revenue credit), the Company would be understating the level of fixed costs being recovered in the volumetric charge. Using a rate schedule specific retail revenue credit is a more appropriate methodology, especially since, as I discuss later in my testimony, any deferrals would be tracked and recovered/rebated separately by rate schedule.

Q. Please describe the third variable in the Decoupling Deferral calculation, "Usage".

A. Usage is the actual booked electric kWh usage for the current time period. As this proposed decoupling mechanism does not have a weather normalization adjustment, the usage for any given time period will be actual per books usage which will be affected by energy efficiency, economic conditions, weather, etc.

Q. Please describe the calculation of the FCER (Fixed Cost Energy Rate), which is the fourth and final component of the Decoupling Deferral equation.

A. I previously stated that the FCC multiplied by the number of actual customers in the rate period sets the authorized total fixed cost recovery level. The next step is then to determine the level of fixed costs actually recovered from the same number of customers. The FCER, multiplied by actual usage in a given time period, equals the actual fixed costs recovered by the Company. The FCER, which is also determined in a general rate case proceeding, is calculated by dividing total fixed costs by the test period kWhs on a monthly basis for each rate schedule. Note that the level of fixed costs in this calculation is the same as that calculated in the FCC. Exhibit No. ___(PDE-10), Page 2,

shows this calculation on a monthly basis. The annual FCER represents how much of each kWh sold is meant for the recovery of fixed costs. The FCER multiplied by the actual number of kWhs sold in the current period is the total fixed costs actually recovered by the Company.

The difference between the amount actually recovered (FCER * USAGE), and the amount authorized for recovery (FCC * CUSTOMERS) will be the calculated Decoupling Deferral. This deferral will either be a surcharge or a rebate. Exhibit No. ___(PDE-10), Pages 5 through 9, show sample calculations for Schedules 1 through 31 of the decoupling deferral using the actual FCC and FCER calculated based on the Settlement Stipulation in this case, and forecasted 2012 customer counts and usage. As you will see, for Schedule 1, based on the 2010 test year (Settlement Stipulation), and 2012 forecasted data, Avista would collect approximately $1.1 million less revenue to cover fixed costs due to an overall reduction in use per customer.

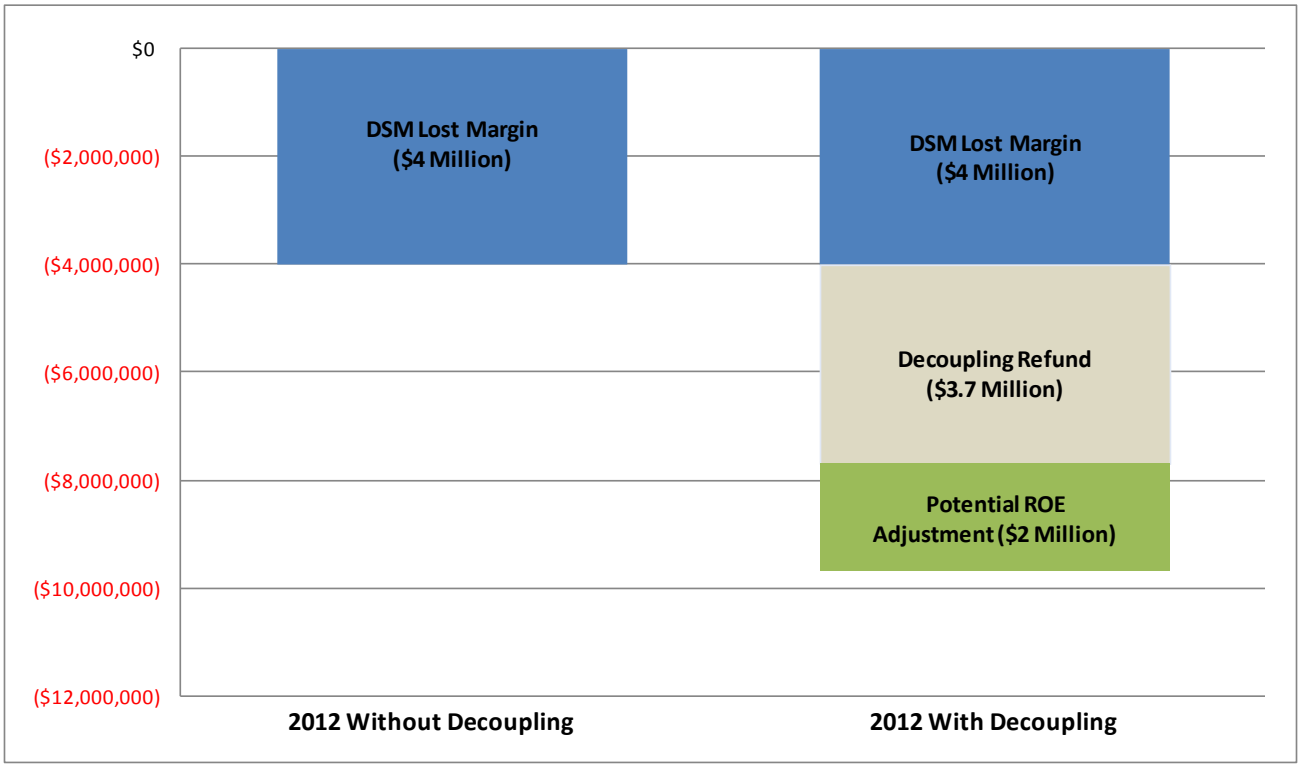
However, as shown on Pages 6 through 9 of Exhibit No. ___(PDE-10), Schedules 11/12, 21/22, 25, and 31/32 are all showing that Avista would collect $4.8 million more revenue to cover fixed costs as all of these schedules are projected to have increased use per customer between 2010 and 2012. The increased revenue by rate schedule is as follows: Schedule 11/12 - $1.2 million; Schedule 21/22 - $2.7 million; Schedule 25 - $0.3 million; and Schedule 31/32 - $0.6 million.

Q. So, if the Company had this mechanism in place for 2012, the Company is forecasting a surcharge to Schedule 1 and a rebate to all other customers?

A. That is correct. Absent a decoupling mechanism the Company would retain approximately $3.7 million which would be used to cover increased costs that will occur

beyond the test-year. With a decoupling mechanism, the Company would rebate $3.7 million. In essence and as shown in Illustration #2 below, with decoupling Avista would still not recover approximately $4 million in DSM lost margin, it would rebate to customers $3.7 million in increased revenues that otherwise would be used to cover increased costs, and potentially lose another $2 million should the Commission order a reduction to the Company's ROE/capital structure.

Illustration #2 – 2012 Pre-Tax Impact With and Without Decoupling



Therefore, as I stated earlier, with decoupling the opportunity for the increased costs from the test year to the rate year to be covered by increased revenues is essentially taken away, i.e., decoupling would take away increased revenues that are intended to cover increased costs under a historical test year ratemaking process such as that employed in Washington.

Q. Why are the FCER rates in Exhibit No. ___(PDE-10), Page 2, shown on a monthly basis?

A. The FCER rates are shaped based on seasonal usage patterns so that the same level of fixed costs is recovered on a monthly basis. The decoupling mechanism described thus far is in essence a proxy for straight-fixed variable rate design. Under such a rate design, the amount of fixed costs recovered on a monthly basis would not change (for Schedule 1, as shown on Page 2 of Exhibit No.___(PDE-10), that amount is $8.7 million per month). Seasonally shaping the FCER based on test year loads in essence does the same thing – if loads are higher in one month, the FCER would be lower, and vice versa – all with the goal of setting the conditions to collect the same amount of fixed costs on a monthly basis. This seasonal shaping can cause some irregularities in terms of calculating the actual fixed costs recovered on a monthly basis. For example, as shown in Exhibit No.___(PDE-10), Page 3, the cumulative reduction in fixed cost recovery for Schedule 1 at June 30, 2013 is approximately $167,000. However, when calculated on an annualized basis, the cumulative reduction in fixed cost recovery was actually $1.1 million as shown on line "hg".

In order to correct for these seasonal issues, the mechanism would have a "12-Months Ended June True-Up Adjustment". This adjustment would use the annual FCER, multiplied by the annual actual kWhs, to determine on a 12-months ending June basis the level of fixed costs actually recovered. That amount would be compared to the 12-months ending June fixed costs authorized to be recovered to determine how much fixed cost recovery occurred. That amount, less the cumulative monthly deferrals would be the "12-

Months Ended June True-Up Adjustment". This adjustment is shown in Exhibit___ (PDE-10), Pages 5 through 9 for each rate schedule (see lines 'ha" through "hg").

Q. Is it the Company's position that the FCC and FCER should be set in a general rate case proceeding?

A. Those amounts can be set in a general rate case, or in a separate proceeding based on the data (revenues, expenses, and billing determinants) approved in the most recent general rate case.

Q. The Company notes that the actual level of kWhs in the rate period will not be adjusted or normalized for the effects of weather. Why isn't the Company proposing to weather-normalize actual usage?

A. The Company has chosen not to normalize usage for the effects of weather for two reasons. First, the proposed electric decoupling mechanism is essentially a proxy for straight-fixed variable rate design. Under that scenario, the fixed costs to serve customers are paid by the customers independent of actual usage (which can be impacted by economic conditions, energy efficiency, weather, etc.). To the extent that the mechanism had various normalization adjustments (economic, weather, etc.), the mechanism would not provide the same level of fixed cost recovery as determined in the last general rate case.

The second reason is that the Commission, in its Policy Statement, listed as one of its "Criteria for Approval" that "(w)e would generally support including the effects of weather in a full decoupling proposal"[8]. To weather-normalize usage may relegate the

[8] Policy Statement, Page 18.

decoupling mechanism to a limited decoupling mechanism, which the Commission suggested in its Policy Statement would not be appropriate for electric utilities.

Q. Do you agree with the NWEC that the proposed mechanism should be applicable to all rate classes except Schedule 25?

A. No, I do not. As I will explain later in my testimony, I believe that the proposed mechanism should be applicable to all rate schedules except Schedules 41-48 (Street and Area Lights).

Q. Do you agree with the NWEC that any decoupling adjustments should be averaged for all classes?

A. No, I do not. Avista believes that the deferral should be tracked by rate schedule, as it is feasible that certain schedules may be in a refund position while others are in a surcharge position, and to average the adjustment could result in cross-rate schedule subsidization.

Q. Can you please describe the accounting for the proposed Electric Decoupling Mechanism?

A. Yes. The Company would record the deferral in account 186 – Miscellaneous Deferred Debits. The amount approved for recovery or rebate would then be transferred into a Regulatory Asset or Regulatory Liability account for amortization. On the income statement, the Company would record both the deferred revenue and the amortization of the deferred revenue through Account 407 - Regulatory Debits and Credits, in separate sub-accounts. The Company would file quarterly reports with the Commission showing pertinent information regarding the status of the current deferral. This report will include a spreadsheet showing the monthly revenue deferral calculation for each month of

the deferral period (July – June), as well as the current and historical monthly balance in the deferral account.

Q. Please provide information related to when the Company would file for a rate adjustment under the proposed Decoupling Mechanism.

A. On or about September 1, the Company would file a proposed rate adjustment surcharge or rebate based on the amount of deferred revenue recorded for the prior July – June period. The results of the "earnings" and "3% Rate Increase Limitation" tests would also be included with the filing and used to determine the amount of the rate adjustment. The "earnings" and "3% Rate Increase Limitation" tests will be discussed later in my testimony.

The proposed tariff included with that filing would include a rate adjustment that recovers/rebates the appropriate deferred revenue amount over a twelve-month period effective on November 1st, which is the same implementation date as the Purchased Gas Cost Adjustment (PGA). The deferred revenue amount approved for recovery or rebate would be transferred to a balancing account and the revenue surcharged or rebated during the period would reduce the deferred revenue in the balancing account. Any deferred revenue remaining in the balancing account at the end of the July-June year would be added to the new revenue deferrals to determine the amount of the proposed surcharge/rebate for the following year. Interest would be accrued in the same manner used for the Company's Energy Recovery Mechanism on the deferral balance only after that balance is approved for recovery/amortization by the Commission[9].

[9] Interest is calculated pursuant to the Settlement Stipulation approved by the Commission's Fifth Supplemental Order in Docket No. UE-011595, dated June 18, 2002. Interest is applied to the average of the beginning and ending month deferral balances net of associated deferred federal income tax. The Company's

COMMISSION'S CRITERIA FOR APPROVAL

Q. In its Policy Statement, the Commission outlined a number of items that a utility should include, at a minimum, in requests seeking a Decoupling Mechanism. Briefly, what are those items?

A. The Commission set forth their "Criteria for Approval" at Page 18 of its Policy Statement. The criteria consist of:

1. Application to Customer Classes
2. Weather Adjustment Mechanism
3. Incremental Conservation
4. Limited-income Impacts/Benefits
5. Duration of Program
6. Reports
7. Other Factors Impacting the Public Interest

In addition to the seven criteria noted above, the Commission elsewhere in its Policy Statement set forth additional conditions that need to be addressed in order to evaluate, and potentially approve, a full decoupling mechanism. Those items include:

8. Address Management's Incentive to Control Costs
9. True-up Mechanism
10. Impact on Rate of Return
11. Earnings Test
12. Accounting for Off-System Sales and Avoided Costs

Q. Please address Criteria #1, Application to Customer Classes.

A. As I mentioned earlier in my testimony, the proposed Decoupling Mechanism should be applicable to all rate schedules except Schedules 41-48 (Street and Area Lights). Street and Area Light rate schedule customers are billed on a flat monthly rate. As such, the fixed costs of providing service to those customers are being recovered by the nature of their rate design.

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weighted cost of debt is used as the interest rate. The interest rate is updated semi-annually and interest is compounded semi-annually.

Apart from those schedules, if we truly want to address the issue of reduced revenue related to energy efficiency savings through a "full decoupling" mechanism, it would be appropriate to include all other rate schedules.

Q. As for item #2, "Weather Adjustment Mechanism", please reiterate the Company's proposal as it relates to the effects of weather.

A. As I discussed earlier in my testimony, the proposed decoupling mechanism does not have a weather normalization adjustment. To the extent that the mechanism had various normalization adjustments (economic, weather, etc.), the mechanism would not provide the same level of fixed cost recovery as determined in the last general rate case.

Q. Please address item #3, the amount of incremental conservation the Company plans to obtain if this proposed mechanism is approved.

A. As the Company has demonstrated in a number of filings before this Commission, it has been aggressively pursuing cost-effective conservation for a number of years. As the Commission notes in its Policy Statement, Washington's Energy Independence Act (EIA), enacted by the voters as Initiative 937 and codified as RCW 19.285, requires electric utilities to "pursue all available conservation that is cost-effective, reliable, and feasible"[10]. Simply stated, the Company is already aggressively seeking all available cost-effective conservation in order to meet its required savings targets. The Company is actively promoting all technologies that are cost-effective, reliable, and feasible, with the goal of meeting and exceeding its required targets.

Quite simply, Avista believes that a properly designed decoupling mechanism, given the requirements under the law related to energy efficiency, should restore the level

[10] Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets, November 2010, Page 3.

of fixed cost recovery already approved in a general rate case. Because the current ratemaking process does not account for the known reduction in kWh sales related to energy efficiency that the Company must attain by law, rates set based on historical test period loads are actually designed to not provide recovery of the Company's costs under normal operating conditions. Therefore, adoption of decoupling should not be conditioned upon the Company achieving an incremental level of energy efficiency.

Q. For item #4, please address whether or not the Company's conservation programs provide benefits to limited-income ratepayers that are roughly comparable to other ratepayers.

A. Overall, we believe the Company's conservation programs do provide benefits to limited-income ratepayers that are comparable to other ratepayers. By far the largest benefit that accrues to all of our retail customers is that, through Avista's energy efficiency efforts, the Company has been able to reduce the need for higher cost incremental sources of energy. The total levelized cost of the Company's electric energy efficiency programs is approximately $41 per MWh based on 2010 actual, unverified savings, which is less expensive than natural gas turbines and wind energy. By avoiding higher cost power sources, the Company's overall power supply costs are lower than they otherwise would have been. Those savings would especially benefit limited-income customers whose energy burdens as a percentage of income is higher than that for non-limited-income customers.

As it relates to the Company's residential energy efficiency programs, all residential customers irrespective of income can participate. Analysis prepared for the Company's limited-income collaborative shows there is evidence that limited-income

customers, and/or their landlords, do participate[11]. Actual participation levels cannot be accurately measured as the Company does not track the income levels of its customers.

Finally, the Company's energy efficiency tariff rider, through Community Action Agencies (CAP), funds limited-income weatherization programs that fund not only 100% of the measure cost, but also an additional 15% for health and human safety investments to preserve the habitability of the residence and preserve the energy efficiency measure. In addition, Avista provides the CAP agencies with an additional payment, equal to 15% of the project cost, to support the CAP agencies administrative costs. Customers who otherwise participate in the Company's regular residential programs typically only receive funding of approximately 57% for the whole cost of the energy efficiency measure, significantly lower than the 100% of the whole cost of the measure limited-income customers receive[12].

Finally it should be noted that the electric limited-income DSM budget accounts for 25% of the overall residential DSM budget. That percentage is roughly equivalent to the percentage of the Company's residential customer base that is considered to be limited-income[13].

Q. Does the Company have a response related to the NWEC's proposal that another "way to advance limited-income customer interests would be to apply any downward decoupling-related rate adjustments to the baseline block of residential consumption, while applying any upward adjustments to the higher-priced tail-block?

[11] Avista Utilities Low Income Energy Efficiency Report, Dockets UE-090134, UG-090135 and UG-060518 (consolidated), Compliance Filing, September 2010.
[12] 2010 Triple E Report.
[13] Avista Utilities Low Income Energy Efficiency Report, Dockets UE-090134, UG-090135 and UG-060518 (consolidated), Compliance Filing, September 2010, Page 4.

A. The Company does not agree with the NWEC's proposal. Such a recovery scheme would add unnecessary complexity to the program both in terms of customer understanding and Company implementation. It would also likely result in an inequitable distribution of any surcharges and rebates to customers. For example, surcharges would go to a subset of customers whose usage tends to be in the tail-block, while rebates would go to a different group of customers. We believe this would be inequitable and inappropriate.

Q. Please address Item #5, the proposed duration of the program, and Item #6, the reports that will be filed with the Commission.

A. The Company believes that a mechanism should not be short-term. The Company agrees with the NWEC that the mechanism should have at least a five-year duration. As I mentioned earlier in my testimony, the Company would file quarterly reports with the Commission showing pertinent information regarding the status of the current deferral. Finally, Avista does not agree with the NWEC as it relates to an independent evaluation in years four and five of the mechanism. After five years all parties would have the opportunity to propose changes to the mechanism, including elimination of the mechanism, and any party could hire a consultant to present their proposed changes if they choose.

Q. With Respect to Item #8, what is the Company's position that without "the risk of recovery of declines in revenue…the utility could lose some of its incentive to manage the company in a manner that constantly looks to reduce costs"?

A. The adoption of decoupling would not result in a reduction of efforts by the Company to operate efficiently. The proposed Decoupling Mechanism would simply provide recovery of fixed costs, on a per customer basis, that were previously approved by

the Commission in a prior general rate case for recovery. To the extent those fixed costs increase, or escalate, over time, the Mechanism would not provide for recovery of the change in costs. The Company would continue to bear the risk of changes in costs between general rate cases, and therefore must manage the business in a prudent manner. Further, the Commission in a general rate case can always make the determination that any of the Company's expenditures were not prudent. This potential for disallowance together with management's desire to provide attractive earnings for shareholders provides enough incentive for management to control costs, and the proposed Decoupling Mechanism does not change that.

Q. With Respect to Item #9, "True-up Mechanism", the Company previously laid out in substantial detail the elements of the Decoupling Mechanism. Do you have any additional points you would like to make regarding this item?

A. No, I do not.

Q. With respect to Item #10, what is the Company's position as it relates to the potential for an adjustment to the Company's rate of return with the Decoupling Mechanism?

A. An adjustment to the Company's rate of return or equity layer is not warranted. As I explained earlier, revenue provided to Avista through a decoupling mechanism would <u>not</u> represent additional revenue to the Company over and above what is needed to recover its costs; it represents <u>restoration</u> of revenues that the Commission has already determined should be provided to the utility from the last rate case. Decoupling would provide a replacement of revenue that the ratemaking process assumes is already present, when in fact the revenue is not realized because of energy efficiency.

Q. Item #11 from the Commission's Policy Statement refers to an Earnings Test? Is the Company proposing an Earnings Test as a part of the mechanism?

A. Avista agrees with the NWEC that recovery of the Company's approved fixed costs of providing service to customers should not be tied to the Company's earnings. That being said, the Company is fully aware that the Commission is desirous of an earnings test based on the Policy Statement. As such, if the Commission requires an earnings test, Avista agrees with the NWEC's proposed test[14]:

> Each year, on or before April 30th, Avista files a Commission Basis Report with the WUTC for electric operations that shows its earned return on investment for the prior calendar year. The calculation is on a normalized basis (actual results are adjusted to reflect retail loads under normal weather conditions, normal hydro conditions, etc.). The adjustments that are made are based on the methods previously approved by the Commission (i.e., Commission Basis). A decoupling earnings test could be filed along with this report, which already has Avista's earned return for the recent calendar year calculated. Any deferrals for the prior calendar year that cause the company's earned return to exceed the authorized return by 25 basis points could be removed from the deferral balance. The Commission could use the 7.62% rate of return in the Stipulation for the authorized return, or if the Commission wants to use a return on equity number, the Commission has the discretion to establish a ROE figure, as part of the decoupling mechanism, for purposes of this test. The Commission could give all parties 90 days to review the Company's filing, with the opportunity to request more time (similar to the existing process used for the annual Energy Recovery Mechanism filing).

Q. Is the Company proposing a DSM test a part of the Electric Decoupling Mechanism?

A. No, it is not. To the extent the Company fails to meet its savings targets required under the Energy Independence Act (RCW 19.285), Avista will face stiff penalties. Failure to meet energy efficiency targets should not penalize the Company in terms of its ability to recover their Commission approved costs.

[14] NWEC Response to Commission Staff Data Request No. 13, November 18, 2011.

Q. Do you agree with the NWEC that there should be a 3% limit on any annual rate increases?

A. Yes I do. Avista also agrees that there would be no limit on any annual rate reductions.

Q. Please describe the 3% Rate Increase Limitation Test.

A. After applying the "earnings" test, the amount of the rate increase resulting from the adjustment is subject to an annual incremental limit of 3%, i.e., the annual increase in the surcharge cannot exceed a 3% rate increase each year, with unrecovered balances carried forward. The incremental surcharge (percentage) increase is determined by subtracting the annual revenue amount recovered by the present surcharge rate from deferred revenue to be recovered through the proposed surcharge rate, and dividing that net amount by the total "normalized" revenue by rate schedule for the most recent July – June period. The normalized revenue is determined by multiplying the weather-corrected usage for the period[15] by the present billing rates in effect. If the incremental surcharge exceeds a 3% rate increase, only a 3% increase is implemented and any excess deferred revenue remains in the deferred revenue account and could be recovered the following year, subject to the 3% limitation. Again, the 3% limitation is not applicable if the Company is in a rebate position.

Q. Please address Item #12, Accounting for Off-System Sales and Avoided Costs.

A. NWEC witness Mr. Cavanagh summarizes this issue in his testimony, and Avista agrees with his position. To the extent that retail sales are lower, and excess

[15] Inclusive of booked billed revenue, booked unbilled revenue and the weather adjustment.

generation can be sold off-system, the net revenues from such transactions flow back to customers through the Company's Energy Recovery Mechanism (ERM). As Mr. Cavanagh correctly states:

> …the ERM tracks wholesale transaction volumes and wholesale prices, and restores to customers the difference between the wholesale price and a "retail revenue credit" that includes generation and transmission costs but not distribution fixed costs. In other words, the ERM is designed to transfer to customers any margin on wholesale transactions in excess of the company's generation and transmission costs. Cavanagh at P. 12, ll. 9-13

Q. Is Mr. Cavanagh correct when he states, at Page 13 of this testimony, that the existing retail revenue credit includes not only the variable cost of generation but also generation and transmission fixed costs?

A. Yes, Mr. Cavanagh is correct that the retail revenue credit, as it exists today, includes fixed costs related to generation and transmission. As I discussed earlier in my testimony, for purposes of a decoupling mechanism, each rate schedule's retail revenue credit should only include the energy classified portion of the production and transmission revenue requirement as established in the Company's cost of service study.

Q. Do you have any concluding comments?

A. Yes, I do. Were the Commission to address the lost margin related to energy efficiency issue in this docket or in a future proceeding, the Company believes that the two methods I discussed previously – the use of a pro forma adjustment based directly on the required energy efficiency kWh savings from the test year to the rate year, or the use of deferred accounting, after the fact, to quantify the lost margin related to the energy efficiency programs, and recover it through a later rate adjustment – are preferable to a decoupling mechanism. These are two methods that are simple and straightforward, and

are consistent with the use of historical test year ratemaking. Unlike a decoupling mechanism, these two approaches do not take away the growth in retail loads and revenues which, under historical test year ratemaking, is necessary to cover a portion of the changes in costs following the test year. These two approaches work in harmony with historical test year ratemaking.

Q. Does this conclude your pre-filed, direct testimony?

A. Yes, it does.