

Exhibit No. ___ T (KLE-1T)
Dockets UE-120436 et al.
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

AVISTA CORPORATION, d/b/a
AVISTA UTILITIES,

Respondent.

DOCKETS UE-120436/UG-120437
(consolidated)

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

AVISTA CORPORATION d/b/a AVISTA
UTILITIES,

Respondent.

DOCKETS UE-110876/UG-110877
(consolidated)

TESTIMONY OF

Kenneth L. Elgin

STAFF OF WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Policy

September 19, 2012

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3 **I. INTRODUCTION**

4 **Q. Please state your name, occupation, and business address.**

5 A. My name is Kenneth L. Elgin. I am a senior financial analyst for the Washington
6 Utilities & Transportation Commission. My business address is, Richard Hemstad
7 Building, S. 1300 Evergreen Park Drive SW, Olympia, Washington 98504.

8 **Q. Please summarize your educational background and professional experience.**

9 A. I earned a B.A. degree in 1974 from University of Puget Sound and an M.B.A. in
10 1980 from Washington State University. I have been employed by the Commission
11 in several different capacities since 1985. My experience is more fully described in
12 Exhibit No. ___ (KLE-3).

13
14 **Q. What is the purpose of your testimony in this proceeding?**

15 A. The purpose of this testimony is to provide the Commission a summary of Staff's
16 responsive case, and respond to the Company's policy witness, Mr. Morris. In
17 separate testimony, Exhibit No. ___ (KLE-2T), I provide Staff's recommendation for
18 Avista's cost of capital.

19
20 **II. SUMMARY OF STAFF CASE**

21
22 **Q. Please provide a summary of Staff's recommendation for increasing Avista's**
23 **rates in this case.**

1 A. Staff is recommending an overall decrease in electric revenues of \$1.31 million or
2 0.3 percent, and an increase in natural gas revenues of \$4.0 million or 2.8 percent.
3 The Company in its direct case is requesting an increase in electric revenues of
4 \$40,983,000 or 9.0 percent and \$10,088,000 or 7.0 percent in gas revenues.
5

6 **Q. Mr. Morris also states that the Company is proposing to refund \$13 million in
7 its deferred power cost accounts, or 2.9 percent as an offset to the general rate
8 increase it seeks in this this case.¹ What is Staff's position on this issue?**

9 A. Staff recommends that the Commission reject this proposal to use credit balances in
10 the ERM deferred account as an offset to the substantial general rate increase
11 proposed by Avista. Staff's position is that any ERM balances should be treated
12 independently; it should not be used to mask any substantial change to general rates.
13 Staff witness Mr. Buckley addresses this issue in his testimony.
14

15 **Q. What are the major issues between the two cases that explain the \$41 million
16 difference in revenue for Avista's electric business and the \$6.2 million
17 difference in revenue for its natural gas business?**

18 A. This primary issue is the fair rate of return. Due to declining cost of capital, Staff
19 case shows a small decrease in electric revenues at this time. In essence, Staff case
20 shows that any attrition the Company may experience due to increasing costs is
21 offset by Avista's reduced cost of capital. Staff case showing an increase in natural
22 gas revenues is driven primarily by the significant increases in costs due to the
23 Company's natural gas safety program.

¹ Exhibit No. ___ (MTT-1T) at 3, lines 18-22.

1 **Q. Please compare Avista's request for fair rate of return, or profit, to what Staff**
2 **believes to be a fair profit.**

3 A. Avista seeks to increase its profits substantially. It is requesting a return on equity of
4 10.9 percent and increasing its ratemaking equity ratio to 48.4 percent. Staff's
5 response case shows that there is a significant decline in the cost of equity, and that a
6 higher equity ratio is not justified. Simply put, Avista's request for higher profits in
7 today's environment is excessive and unreasonable. Staff is recommending a 9.0
8 percent return on equity and an equity ratio of 46.0 percent. I present Staff's cost of
9 capital analysis in my Exhibit No. ___ (KLE-2T).

10

11 **Q. Did Staff prepare an attrition study in this case?**

12 A. Yes. Staff is presenting its own attrition study in response to Avista's analysis.
13 Consistent with past practice, Staff's attrition analysis considers all factors affecting
14 the relationships between revenues, expenses and rate base likely to prevail in the
15 rate year. Staff witness Ms. Breda conducted the attrition analysis for Staff.

16

17 **Q. What other differences account for the significant difference between the**
18 **Company's direct case and Staff's response case?**

19 A. Staff's case shows a decrease in power supply costs to recognize updated costs for
20 electric generation and other changes compared to the values the Company used in
21 its direct case. Staff understands this update of power costs will not be a substantial
22 matter of controversy.

1 There are several other major corrections and updates to several items in
2 Avista's direct case. Staff's response case includes these items. These adjustments
3 and corrections are summarized in the exhibits of Ms. Huang and Mr. Keating.

4
5 **Q. Do you have any specific comments about Staff's presentation on the attrition**
6 **analysis?**

7 A. Yes. Staff is conducting an attrition analysis for the first time in over twenty years.
8 Staff believes an attrition analysis is the proper approach in circumstances where a
9 utility allege it persistently fails to realize a fair return. An attrition study considers
10 all elements of the ratemaking formula: revenues, expenses, rate base and rate of
11 return in order to judge whether those relationships in the rate year will be materially
12 different than those in the test year. An attrition study also is the proper means to
13 adjust rate year loads for any effects of conservation programs.

14 However, the Commission should recognize that an attrition study relies on
15 estimates of future rate year relationships of revenue, expenses and rate base. As
16 such, these adjustments require informed judgment and careful evaluation.

17 Furthermore, I want to point out what the Commission stated in a 1981
18 Avista rate order on attrition and the circumstances it believes are necessary in order
19 to provide the allowance:

20 Upon examination of the detailed analysis of Mr. Louiselle's testimony and
21 supporting exhibits, we are convinced that in order to preserve and maintain
22 the company's financial integrity and allow it to generate sufficient cash flow
23 consistent with its needs for construction projects, and to attract investors at a
24 reasonable cost, the staff's attrition allowance should be accepted. In
25 accepting the attrition allowance proposed herein, we emphasize that such an
26 adjustment for this or any other utility under our jurisdiction will be
27 considered on a case-by-case basis. We further state that the evidence

1 adduced to support an attrition allowance must be of such a character that
2 will lead us to a firm conviction that not to do otherwise will jeopardize the
3 company's financial integrity and adversely affect the ability of the company
4 to render required service to its customers at reasonable rates.²
5

6 The Commission order indicates that attrition adjustments should be used
7 carefully and in circumstances when it is necessary to preserve the financial integrity
8 of a utility, and enable it to attract capital on reasonable costs. In this case the
9 Commission is not confronted with these circumstances. Staff case does not seek to
10 apply that standard. Staff believes an attrition adjustment is a proper tool to use
11 when there is good evidence that the rate year will be materially different to the test
12 period impacting the utility's opportunity to earn a fair return. Nonetheless, the
13 above order prompts us to be mindful that an attrition allowance must be used with
14 caution, and the adjustment should be viewed in the context of the final result of the
15 rate order and after consideration of all factors in the rate setting process.
16

17 **Q. Why should this be of concern to the Commission?**

18 A. The concern is the degree to which the attrition analysis becomes the means to
19 guarantee Avista's earnings. The circumstances in this case are a perfect example of
20 why the Commission should use the attrition allowance with caution. In preparation
21 of Staff's case, it sought data in supporting the load and revenue forecast used in the
22 Company's direct case for its attrition study. After providing the information, in late
23 July, Avista supplemented its response to that data request with a revised load
24 forecast. The effect of the Company's revised load forecast would increase Avista's
25 attrition allowance significantly.

² *Utilities and Transp. Comm'n v. The Wash. Water Power Co.*, Cause Nos. U-81-15 & U-81-26, Second Supplemental Order (November 25, 1981), at 22.

1 This reflects an apparent perspective from Avista that the attrition allowance
2 must “make the Company whole” for any revisions to its forecast of rate year loads
3 and revenues. If that is the case, then the entire risk/return landscape tilts in favor of
4 the Company. Staff’s analysis does not fully accept either forecast as it is arguable
5 whether that update should be considered at all. Instead, Staff created its own
6 estimate of rate year loads and revenues in its study. In conclusion, the Commission
7 should be cautious when considering estimates of the future for purposes of
8 determining a fair rate.

9
10 **Q. The Commission ordered Avista to prepare a study on executive compensation.
11 Is Staff providing a response to Avista case on that issue?**

12 A. Yes. Staff addresses executive compensation. Among other things, Staff makes an
13 adjustment to reduce Avista’s executive compensation expense, using the study that
14 Avista filed in response to the Commission’s order. Staff witness Ms. Huang
15 testifies to this adjustment.

16
17 **Q. How is Staff treating the Company’s new \$200 million ten-year natural gas
18 pipeline replacement program?**

19 A. Staff’s case accepts the Company’s rate treatment of the costs to Washington of the
20 Company’s pipe replacement program. Washington represents roughly half of that
21 \$200 million program. Staff is providing testimony on the Company’s Distribution
22 Integrity Management Program (DIMP). In that testimony Staff identifies this pipe

1 as the second highest safety risk to Avista and its customers, and Avista's DIMP is
2 reliable for making this assessment.

3 I note in particular that Avista established this pipe replacement program
4 without any special regulatory incentives.

5 Staff witnesses Mr. Lykken and Mr. Mickelson testify on the pipe
6 replacement program.

7

8 **Q. Do you have any other comments with respect to the Company's natural gas
9 safety program and its effect on the cost of natural gas service?**

10 A. Yes. This case is recognizing significant cost increases for Avista's natural gas
11 business due to the natural gas safety program. First, the Company includes a
12 significant increase in depreciation expense for gas mains. Second, the Company
13 has added rate base and expense associated with replacement of the Aldyl-A pipe.
14 Third, the Company reflects increases in operating expense associated with more
15 frequent leak surveys. Finally, this case includes the costs of the Company's DIMP.

16

17 **Q. Please summarize Staff's position on the Company's decision to enter into a
18 purchased power contract for additional renewable resources to meet its
19 requirements under Washington statutes.**

20 A. Staff determined Avista was prudent in its decision to acquire new wind generation
21 under the terms of that contract to meet its obligations to acquire additional
22 renewable resources. Staff witness Mr. Nightingale testifies on this issue.

23

1 **Q. Please summarize Staff's position with respect to ratepayer funding for low**
2 **income grants.**

3 A. Staff is recommending that there be no increase in ratepayer funding for low income
4 grants. Staff recommends Avista change its program to a rate discount program in
5 its next general rate case, and changes to the process of certifying eligible customers.
6 Staff witness Ms. Reynolds testifies on this issue.

7

8 **Q. Please summarize Staff's position on rate spread and rate design?**

9 A. With respect to rate spread, Staff is proposing a small movement to parity between
10 customers. Staff is also proposing changes in the basic rate design for residential
11 customers in both electric and natural gas services. These changes include higher
12 basic charges and changes to the volumetric rates for different levels of use by
13 customers. Staff witness Mr. Mickelson testifies on cost of service, rate spread and
14 rate design.

15

16 **III. RESPONSE TO AVISTA'S POLICY TESTIMONY**

17

18 **Q. Would you briefly summarize the testimony of Mr. Morris, Avista's CEO and**
19 **policy witness in this case?**

20 A. The general theme of Mr. Morris' policy testimony is that the rate request is essential
21 to cover the Company's increasing costs of providing service to its customers,³ and
22 that Avista has undertaken significant measures to cut costs to mitigate rate increases

³ Exhibit No. ___ (SLM-1T) at 2, lines 4-10.

1 for its customers.⁴ On this latter point, Mr. Morris states, “In the past several years
2 we have also made substantial cuts in our capital budget in order to mitigate rate
3 impacts to customers.”⁵ He then goes on to state that Avista maintain[s] tight
4 controls on capital and O&M budgets...”⁶ Finally, Mr. Morris states that there is
5 only so much Avista can do to cut costs due to its obligation to serve.⁷
6

7 **Q. What comments do you have about the statements with respect to controlling
8 the capital budget expenditures?**

9 A. Staff acknowledges that the Company has plans for \$250 million in capital
10 expenditures for the next two years.⁸ Mr. Morris specifically identifies a \$19 million
11 reduction in the total capital budget that he describes as “substantial”.⁹ From my
12 perspective, a \$19 million reduction in an initial budget proposal of \$269 million is
13 not “substantial”. In fact, this is the lowest reduction Avista has made in several
14 years to its initial construction budget.
15

16 **Q. What is Staff’s response to the elements of the Company’s policy testimony
17 regarding rising expenses?**

18 A. In general, Staff’s case recognizes the overall trend of increasing costs for Avista, as
19 it has in previous cases. Staff’s attrition study also captures these cost increases
20 reasonably expected for the rate year.

⁴ This part of Mr. Morris’ testimony appears to respond to the requirement in WAC 480-07-510 (3)(g).

⁵ Exhibit No. ___ (SLM-1T) at 4, lines 22-23.

⁶ Id. at 5, lines 3-4.

⁷ Id. at 5, lines 10-12.

⁸ Avista’s response to Staff Data Request 279 C at 10.

⁹ Exhibit No. ___ (SLM-1T) at 4, lines 22-23.

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Q. What about the testimony regarding impact of the Company’s obligation to provide service and its cost to serve new customers?

A. Despite the testimony that the Company has no choice to serve new customers¹⁰, there are limits. The obligation to serve is not absolute. Although I cannot render a legal opinion, RCW 80.28.110 states that the company shall provide service to those reasonably entitled to receive available energy. Avista’s line extension tariff is good example of how it limits the cost to serve new customers.

Second, in order to provide natural gas service, the Company sought and received from the Commission a certificate of public convenience and necessity outlining the specific areas the Company elected to serve. In other words, natural gas is a discretionary service and the Company has identified where it wishes to serve.

Q. Finally, with respect to other costs to provide service, how do the presentations of Staff and Avista differ?

A. As with any rate case, there are the typical contested adjustments and corrections to the Company’s case that became apparent during discovery, and these are included in Staff’s presentation. Several of these items will be uncontested.

Q. What other comments do you have with respect to Avista’s policy testimony about rising costs and the need for higher rates?

¹⁰ Exhibit No. ___ (SLM-1T) at 6, line 14.

1 A. Mr. Morris' testimony about cost increases between 2005 and 2011¹¹ is not a
2 balanced presentation; he ignores the substantial rate increases Avista's customers
3 have experienced since 2005. This case is about the relative change in costs for the
4 2011 test period and whether Avista needs additional revenues for that change in
5 costs.

6
7 **Q. To provide balance to the record, please state Avista's rate increases over the**
8 **2005-2011 time period.**

9 A. Since 2005, Avista's electric rates have increased 48 percent and its natural gas rates
10 have increased by 17 percent. These rate increases to cover the rising costs outlined
11 in the Company's testimony. Exhibit No. ___ (KLE-5) is Avista's response to Staff
12 Data Request 265. The increase in rates is calculated by taking the cumulative effect
13 of electric and gas increases since Docket UE-050482.

14
15 **Q. Mr. Morris provides testimony regarding the rising costs for new**
16 **infrastructure. What comments do you have with respect to this testimony?**

17 A. The testimony is also one-sided, because it fails to recognize or compare how
18 changes in rates have related to those rising costs.

19 For example, Mr. Morris provides a chart comparing the relative cost of new
20 power poles with those costs in prior decades.¹² His chart shows that the cost index
21 for poles in the year 2000 is 30 percent lower than the cost in 2010. However, rates
22 in 2010 are substantially higher than they were in 2000. In fact, electric rates today

¹¹ Id. at 10: Illustration 1.

¹² Id. at 8: Illustration 2.

1 are 88 percent higher than in 2001. Exhibit No. ___ (KLE-5) is Avista's response to
2 Staff Data Request 265. The increase in rates is calculated by taking the cumulative
3 effect of electric increases since Docket UE-011595.

4

5 **Q. Please summarize Staff's response to Avista's policy testimony regarding its**
6 **costs and need for new rates to recover its rising costs.**

7 A. In general, the theme of rising costs is not new; it has been present for Avista, and all
8 energy companies, for some time now. Staff's case recognizes the increases the
9 Company is experiencing as presented in the test year. However, the need for
10 increased profit is unnecessary. Staff's case shows that the electric business has no
11 need for higher rates due in today's declining cost of capital markets, and a modest
12 need for an increase in natural gas rates to recognize the increased costs of Avista's
13 safety and pipe replacement program.

14

15 **IV. IDENTIFICATION OF STAFF WITNESSES**

16

17 **Q. Would you briefly identify each Staff witnesses and the subject of his or her**
18 **testimony?**

19 A. Yes. As I mentioned earlier, I provide separate testimony on cost of capital. The
20 other Staff witnesses presenting testimony in this case address the following
21 subjects:

- 22 • Ms. Kathryn Breda: Attrition and various accounting adjustments;

- 1 • Ms. Johanna Huang: Electric results of operation statement and various
2 accounting adjustments, including executive compensation;
- 3 • Mr. E.J. Keating: Natural gas results of operations, cost of debt and various
4 accounting adjustments for electric operations;
- 5 • Mr. Alan Buckley: normalized power supply and ERM-related issues;
- 6 • Mr. Christopher Mickelson: allocated cost of service; rate spread and rate design;
7 natural gas pipeline replacement program;
- 8 • Mr. David Nightingale: prudence of smart grid investment and the Palouse power
9 contract for new renewable generation;
- 10 • Mr. Michael Foisy: working capital and property taxes;
- 11 • Ms. Deborah Reynolds, decoupling and low-income;
- 12 • Mr. David Lykken, natural gas safety programs;

13

14 **Q. Does this conclude your direct testimony summarizing the Staff's direct case**
15 **and responding to Avista's policy witness?**

16 **A. Yes.**