Exhibit No. ___(RJF-1T)
Docket No. UE-060181
Witness: Randall J. Falkenberg

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of AVISTA CORPORATION, d/b/a AVISTA UTILITIES, For Continuation of the Company's Energy Recovery Mechanism, with Certain Modifications.	)	**Docket No. UE-060181**

DIRECT TESTIMONY OF

RANDALL J. FALKENBERG

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

April 21, 2006

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Randall J. Falkenberg, PMB 362, 8351 Roswell Road, Atlanta, Georgia 30350.

Q. WHAT IS YOUR OCCUPATION AND BY WHOM ARE YOU EMPLOYED?

A. I am a utility rate and planning consultant holding the position of President and Principal with the firm of RFI Consulting, Inc. ("RFI"). I am appearing in this proceeding as a witness for the Industrial Customers of Northwest Utilities ("ICNU"). My qualifications are presented in Exhibit No.___(RJF-2).

Q. WHAT KIND OF CONSULTING SERVICES ARE PROVIDED BY RFI?

A. RFI provides consulting services in the electric utility industry. The firm provides expertise in electric restructuring, system planning, load forecasting, financial analysis, cost of service, revenue requirements, rate design, and energy cost recovery issues.

I. INTRODUCTION AND SUMMARY

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. My testimony addresses the continuation of Avista's (or the "Company") Energy Recovery Mechanism ("ERM") and the Company's proposed changes to the ERM.

Q. WHAT ARE ICNU'S RECOMMENDATIONS REGARDING THE ERM?

1. **ICNU recommends that the Commission reject Avista's proposal to eliminate the ERM deadband and require Avista to include allocated common costs as part of the power production factor.**

2. **Avista's proposed changes to the ERM fail to meet the principles established by the Commission in the recent PacifiCorp case, Docket No. UE-050684. Most significantly, the Avista proposal contains no deadband, and does not equitably allocated power cost risks between ratepayers and shareholders.**

3. **ICNU recommends the Commission modify the ERM deadband and sharing mechanism to include a $5.0 million deadband, a 50/50 sharing band for power cost variations from $5.0 to $13.0 million, and a 90/10 sharing band for variations in excess of $13.0 million. ICNU also proposes that the Commission integrate an earnings test into the modified deadband and sharing mechanisms that would result in no power cost deferrals when Avista's return on equity ("ROE") is within 100 basis points of its last allowed ROE.**

4. **ICNU recommends the Commission adopt specific requirements to govern the ERM process, including developing minimum filing requirements. These steps will help ensure that parties have a reasonable opportunity to review the ERM deferral requests filed by Avista.**

5. **In its order in Docket No. UE-050684, the Commission stressed the primary purpose of a power cost adjustment mechanism ("PCA") such as the ERM was to deal with cost variability due to weather variations. Hydro variation is by far the most important weather impact on Avista's costs. To provide the Commission an alternative to the ERM that tracks only the impacts of unusual hydro conditions, ICNU proposes a "Hydro Hedge Tariff" arrangement between ratepayers and Avista. This tariff would apportion hydro variation risks in an equitable and revenue neutral manner.**

6. **Finally, as noted by ICNU witness Michael Gorman, if the Commission reduces or eliminates the ERM deadband, it also should recognize the significant decreases in Avista's cost of debt as a means to reduce Avista's power cost deferral balance and require Avista to demonstrate that it has implemented a prudent hedging strategy.**

II. ENERGY RECOVERY MECHANISM

Purpose of the ERM

Q. WHAT IS THE PURPOSE OF THIS PROCEEDING?

A. The purpose of this proceeding is to conduct a "comprehensive review" of Avista's ERM "to consider whether continued operation of the ERM is in the public interest and, if so, whether changes to the deadband and other features of

the ERM are required."[1/] For purposes of this review, I recommend the Commission address the following issues:

- What is the present purpose of the ERM?
- Should the Commission adopt rules to govern the ERM?
- Should Avista's ERM be retained or modified?
- If so, how should the ERM mechanism be structured to properly achieve its desired purpose?

Q. WHAT WAS THE *ORIGINAL* PURPOSE OF THE ERM?

A. The ERM was implemented as a result of a settlement between all parties to Docket No. UE-011595. At the time, Avista was suffering from serious financial setbacks due to the Western power crisis, below-normal hydro conditions, and poor performance of risky unregulated trading operations. In its Order adopting the Stipulation in Docket No. UE-011595, the Commission cited the Staff memorandum supporting the Stipulation. The Staff memorandum (as quoted by the Commission in its Order) discussed the context in which the Stipulation was adopted and highlighted several benefits of the Stipulation. Staff concluded that the Stipulation:

- Resolves the uncertainty with respect to the Company's exposure to extraordinary power costs during 2000 and 2001.
- Implements an energy cost recovery mechanism, with an appropriate sharing of risk between shareholders and ratepayers, consistent with traditional rate base, rate of return regulation.
- Provides an orderly way for the Company to recognize in its financial statements the change from deferred power cost accounting to the proposed ERM.

[1/] WUTC v. Avista, WUTC Docket No. UE-050482, Order No. 5 at ¶63 (Dec. 21, 2005).

- Provides an opportunity for the parties to review issues related to power supply recovery under the ERM in 2006.

- Provides Avista with a reasonable opportunity to turn its financial situation around and to restore the investment community's faith in the Company.

- Provides Avista with the opportunity to regain an investment grade rating on its securities, which will translate into customer benefit.[2/]

The ERM was implemented to resolve a severe financial situation the Company was experiencing during a period that was most certainly not "business as usual." The original purpose of the ERM was to provide financial relief for the Company at a time when it faced dire circumstances, but in a way that equitably apportioned risk between ratepayers and shareholders.

Q. IS THE CURRENT ERM STILL NECESSARY TO ACHIEVE ALL OF THESE GOALS?

A. Not necessarily. The primary uncertainty facing Avista in 2001 was the western power crisis and the resulting balance of unrecovered power costs. The Commission could bring final resolution to that problem by simply changing the ERM to a surcharge designed to collect the remaining deferral balance over a definite period of time. Consequently, the continuation of the current ERM is not an absolute necessity. However, given Avista's current "sub-investment grade" status and the fact that the Commission declined ICNU's proposal to terminate the ERM in Docket No. UE-050482, ICNU proposes continuation of the ERM with suitable modifications necessary to fairly apportion power cost risks between ratepayers and shareholders.

[2/] WUTC v. Avista, WUTC Docket No. UE-011595, Memorandum of Staff Explaining Settlement Stipulation at 2-3 (June 3, 2002).

Q. ELABORATE ON THE GOAL OF AVISTA REGAINING ITS INVESTMENT GRADE STATUS.

A. Certain recovery of the deferral balance, whether through the ERM or a surcharge, along with the substantial rate increase just granted to the Company in Docket No. UE-050482, would provide additional support for Avista's drive to improve its corporate credit rating. However, it is ultimately up to the Company to improve its credit rating, not just the customers. By requesting approval to eliminate the ERM deadband, the Company is proposing to treat ratepayers as little more than an "ATM machine" for any problem or cost it faces. Instead of this approach, the Commission should place the onus on the Company to take whatever steps are needed to improve its financial health. It is possible that the Company may need to cut costs or even to file general rate cases to reach its financial goals. Mr. Gorman addresses the financial aspects of this problem in more detail.

Q. PLEASE COMMENT ON AVISTA'S CLAIM THAT ABSORBING COSTS THROUGH THE ERM DEADBAND HAS HINDERED THE COMPANY'S EFFORTS TO RETURN TO INVESTMENT GRADE STATUS.

A. Both Mr. Norwood and Mr. Malquist emphasize that Avista has absorbed approximately $31.5 million due to the ERM deadband since 2002, and Mr. Malquist states that absorbing these costs undermines the Company's ability to return to investment grade status.[3/] These witnesses fail to note, however, that all parties, including Avista, contemplated at the time the ERM was established through a settlement stipulation that the Company would absorb through the deadband the costs of certain above-market gas contracts that Avista executed in

[3/] Exh. No.___(KON-1T) at 8; Exh. No.___(MKM-1T) at 3-4.

2001. Avista confirmed this in the joint testimony in support of the stipulation in the Company's last rate case, stating that at "the time of the settlement in May 2002, the forward price of natural gas was lower than the price in the contracts, and it was understood that, absent other changes in power supply-related costs, the Company would absorb a portion of the cost of the contracts through the deadband."[4/] Although Avista's current testimony in this case seems to indicate that the deadband has operated in a punitive manner that has contributed to the Company's financial situation, in reality the deadband has operated as intended.

Q. GIVEN THE IMPROVEMENT IN AVISTA'S FINANCIAL CIRCUMSTANCES DETAILED BY MR. GORMAN, WHAT SHOULD BE THE PURPOSE OF THE ERM ON A GOING FORWARD BASIS?

A. As noted above, a primary purpose of the ERM is still to devise "appropriate sharing of risk between shareholders and ratepayers, consistent with traditional rate base, rate of return regulation."[5/] Now that Avista's financial improvement is well underway, the ERM should focus more on equitably apportioning the risk of power cost variations over time. A properly designed ERM can further this objective, but the current ERM and Avista's proposed changes to the ERM do not. The goal of obtaining full investment grade status is still important, but, as noted above, that should now be more up to the Company than to the customers.

[4/] WUTC v. Avista, WUTC Docket No. UE-050482, Exh. No. 1 at 26:4-7 (Aug. 26, 2005).
[5/] WUTC Docket No. UE-011595, Memorandum of Staff Explaining Settlement Stipulation at 2.

Q. IN THE RECENT PACIFICORP CASE (DOCKET NO. UE-050684, ORDER NO. 4), THE COMMISSION ARTICULATED THE PRINCIPLES APPLICABLE TO A PROPER PCA. DO THE COMMISSION'S PRINCIPLES APPLY IN THIS CASE?

A. Yes. In Order No. 4, the Commission stated "that a properly designed mechanism should address the following principles:

- **The purpose is to recognize variability in the cost of operating *existing* power supply resources as a result of abnormal weather conditions that are out of a utility's control**. Ratepayers understand the connection between weather and rates;

- PCAs are *short-run* accounting procedures to address *short-run* cost changes resulting from unusual weather;

- It is not appropriate to include new resources in a power cost adjustment mechanism. New resources must be considered in general rate cases or power cost only rate cases;

- **Ratepayers should receive the benefit of a reduction in cost of capital**, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders, and;

- Power cost adjustment mechanisms should not interfere with least cost planning, conservation or other regulatory goals."[6/]

The Commission further stated:

> **[P]ower cost recovery mechanisms should also apportion risk equitably between ratepayers and shareholders**. In striking that balance, we consider risks already allocated through the normalization process, a utility's financial condition and other circumstances affecting a utility's ability to recover its prudent expenditures. Deadbands and sharing bands are useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs.[7/]

[6/] WUTC v. PacifiCorp, WUTC Docket No. UE -050684, Order No. 4 at ¶91 (Apr. 17, 2006) (emphasis added) (internal citations omitted).

[7/] Id. at ¶96 (emphasis added).

The Commission also acknowledged that the "application and appropriateness of these principles must take into account the specific circumstances facing the utility. We agree with Staff that all power cost adjustment mechanisms for Washington utilities need not be the same."[8/]

I will demonstrate that Avista's proposed changes to the ERM fail to meet many of the Commission's principles discussed above.

Q. DO AVISTA'S PROPOSED CHANGES TO THE ERM EQUITABLY ALLOCATE THE RISK OF POWER COST VARIATIONS TO THE PARTIES BEST ABLE TO MANAGE THOSE RISKS?

A. No. Avista proposes to eliminate the ERM deadband, and effectively allocate 90% of all net power cost risk to ratepayers. However, ratepayers have no influence over the decisions that drive power cost variations and generally do not have access to risk management tools to mitigate such risks. Avista, on the other hand, can undertake prudent risk management strategies to manage its power cost risks. Even if Avista is not successful in its risk management, investors have the opportunity to develop a portfolio of investments to diversify their risks, thus eliminating exposure to the power cost risks of a single company such as Avista. As noted by Mr. Maury Galbraith, an Oregon Public Utility Commission ("OPUC") Staff witness in a recent proceeding concerning power cost adjustments in Oregon, "[i]t is much more efficient to have the financial markets diversify [net variable power cost] risk, than to allocate the risk to customers and have them bear it."[9/] As a result, ratepayers should not be allocated almost all power cost risks as proposed by the Company. Instead, an equitable risk sharing

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[8/] Id. at ¶91.

[9/] Re PGE, OPUC Docket No. UE 165, Staff/100, Galbraith/9 (Feb. 14, 2005).

arrangement should be implemented, as the Commission has already stated in Docket No. UE-050684.

Q. WOULD RETENTION OF THE CURRENT ERM OR ADOPTION OF AVISTA'S PROPOSED ERM BE A GOOD POLICY DECISION FOR THE COMMISSION?

A. No. There are many policy concerns associated with the current ERM. The ERM in its current form fails to strike a reasonable balance between ratepayers and shareholders, and Avista's proposed modifications would be even worse for customers. Further, in the current environment, the ERM creates disincentives to maintain or increase investment in generation, promotes "gaming" of accounting entries, and fails to properly distinguish between those costs that are controllable by the utility and those that are not.

Q. EXPLAIN WHY THE CURRENT ERM FAILS TO STRIKE A FAIR BALANCE BETWEEN THE INTERESTS OF RATEPAYERS AND SHAREHOLDERS.

A. A major problem with both the current ERM and especially Avista's proposed modifications is that they could provide relief to ratepayers or shareholders regardless of the underlying financial circumstances of the Company. For example, it is possible that the ERM could provide ratepayer refunds in a good hydro year, even though the Company might have very poor earnings at the time. This could occur due to sales declines in a recession, for example. Conversely, in a year with high power costs, but strong earnings, the Company could reap a windfall, which could occur as a result of rapid sales growth, tax cuts, or other favorable circumstances.

Q. DOES THE CURRENT ERM OR AVISTA'S PROPOSED MECHANISM CREATE DISINCENTIVES FOR EFFICIENCY?

A. Yes. Any automatic adjustment clause provides a utility with an incentive to purchase wholesale energy rather than increasing or even retaining investment in generation. The reason for this is that by decreasing generation investment, return requirements decrease, thereby reducing the need for base rate increases. If there is a pass-through mechanism for fuel and purchased power, the utility may prefer to simply minimize investment and instead purchase high cost fuel and energy in the market.

Such situations do not always arise from to the decision to build new generating capacity or purchase power. In fact, many types of efficiency improvements requiring capital investment may be avoided when an automatic adjustment clause is present. The investments in question may not even involve generating capacity. Transmission upgrades might also be minimized, at the expense of higher purchased power costs, given the presence of the ERM.

An automatic adjustment clause also causes major differences between the revenue effects of different kinds of resources and the accounting treatment of different kinds of costs. Variable power supply expenses are passed through in the ERM, while investments are not. Without an automatic adjustment clause, the Company will have the incentive to minimize costs between rate cases, and would naturally select the lowest cost resources. With an automatic adjustment clause, the Company may have a financial incentive to select resources that are afforded full pass-through recovery, irrespective of their total cost to customers.

As just one example, consider a situation where Avista might have an unfavorable coal-supply contract or had a supplier default on a contract. In both cases, the Company would likely incur legal expenses to undertake litigation with the supplier. However, with an automatic adjustment clause, legal expenses are not a pass-through but fuel and purchased power are.[10/] In both cases, the Company would have much less incentive to undertake the litigation necessary to obtain relief with a pass-through mechanism.

Q. CAN YOU PROVIDE MORE EXAMPLES OF HOW AN AUTOMATIC ADJUSTMENT CLAUSE MIGHT DISCOURAGE PRUDENT OR EFFICIENT MANAGEMENT?

A. Yes. Currently utilities are experiencing disruptions in Powder River Basin coal deliveries due to problems with the Union Pacific and Burlington Northern & Santa Fe railroads. In fact, at least 20 utilities have reported delivery problems. Obviously, an ample coal inventory is the best insurance against a supply disruption, but coal inventories are generally fixed costs included in base rates. With an automatic adjustment clause, however, fuel is largely a pass-through. Between rate cases, coal inventories are a "utility cost" but fuel and purchased power are "ratepayer costs" when pass-through accounting is used. As a result, the utility could see an advantage in carrying a minimal coal inventory between rate cases, irrespective of the impact on total costs to customers of supply shortfalls.

Outage costs are another example. Outages can be reduced through a program of preventive maintenance and other "best practices." However, outage

[10/] This is not purely hypothetical. I have been involved in cases in which utilities requested inclusion of legal fees in fuel cost recovery because, absent this recovery, they did not have the incentive to mount legal challenges to fuel supply contracts.

costs are largely a pass-through under automatic adjustment clauses, while the higher O&M expenses associated with reducing outages are not. Consequently, the Company has little incentive to incur the additional costs needed to minimize outages.

Capacity upgrades present a similar problem. The costs of upgrading the capacity of a unit are generally fixed and not recoverable in automatic adjustment clauses. However, if capacity is upgraded, then variable power costs will decline. Under an automatic adjustment clause, the Company would not have as much incentive to upgrade its capacity, because shareholders would absorb the investment cost prior to the next rate case, while ratepayers would enjoy the benefits.

Ultimately, sensitivity to cost is simply not as great when costs are passed through to customers. The prices paid for purchased power become much less important to shareholders when the ratepayers are responsible for paying all or a significant portion of these costs between rate cases. The self-interest of shareholders is perhaps the greatest regulatory force of all. Regulatory lag *between* rate cases creates pressure on the part of management to minimize costs. This provides incentives to minimize outages and use the least cost power supply strategy.

Q. DOES THE OPPORTUNITY TO CONDUCT AN AUDIT AND PRUDENCE REVIEW AFTER THE ERM DEFERRALS ARE RECORDED PROVIDE PROTECTION FOR RATEPAYERS?

A. A prudence review is a necessary component of authorizing a utility to include any costs in rates; however, an after-the-fact audit and prudence review of excess

power costs recorded under a mechanism such as the ERM is unlikely to effectively ensure that customers do not pay for costs that are imprudent or otherwise inappropriate for recovery. A retrospective review of the costs that Avista incurred in response to the various factors that may affect the Company's power costs is a complex and administratively burdensome task. Furthermore, as WUTC Staff witness James Russell recognized in the last Puget Sound Energy ("PSE") rate case, an after-the-fact review of deferred costs "shifts the burden of proof from the utility to the Commission and its Staff to find the excessive or imprudent dollars in multi-year deferrals versus the utility having to justify a normal level of expenses in a rate case."[11/] Given the complexity associated with such a review, it cannot be relied on to fully protect ratepayers.

Q. DOES THE CURRENT ERM PROTECT RATEPAYERS AGAINST GAMING OF ACCOUNTING ENTRIES TO MAXIMIZE THE UTILITIES' REVENUES?

A. The ERM itself does not provide for specific rules or minimum filing requirements to govern the process of reviewing accounting entries under the ERM or the amounts deferred. ICNU, Staff, Public Counsel, and Avista agreed in the first ERM review proceeding (Docket No. UE-030751) to certain minimum filing and informational requirements for Avista's filings to initiate the annual review of ERM deferrals.[12/] If the Commission continues the ERM or approves another power cost recovery mechanism for Avista, it should require an annual review of the amounts deferred under that mechanism and establish permanent procedural requirements governing that review. The requirements agreed to by

[11/] WUTC v. Re PSE, WUTC Docket Nos. UE-040641 et al., Exh. No. 421 at 22:7-11 (Russell Direct) (Sept. 23, 2004).

[12/] WUTC v. Avista, WUTC Docket No. UE-030751, Order No. 5 at ¶23 (Feb. 3, 2004).

the parties in Docket No. UE-030751 represent the minimum required to provide a complete review to ensure that ratepayers do not pay for costs that are not fair, just, and reasonable.

Q. COULD YOU CHARACTERIZE THESE ADDITIONAL PROBLEMS INHERENT IN THE ERM AS ADDITIONAL RISK FACTORS FOR CUSTOMERS?

A. Yes. While the Avista witnesses characterize the ERM as reducing risk for the Company, in reality, it increases the overall level of risk borne by customers. The current ERM (and this is even more true for Avista's proposed modifications) adds an additional layer of risk on top of power cost risks currently faced by customers. Not only do customers face risk of power cost variations, but they would also face risks "induced" by the presence of the ERM related to inefficient management and the gaming of accounting entries.

Q. GIVEN THESE PROBLEMS, ARE THERE ANY BENEFITS TO THE ERM THAT JUSTIFY THE IMPOSITION OF THESE ADDITIONAL RISKS ON CUSTOMERS?

A. Mr. Gorman discusses the possibility of the benefit of reduced credit costs. While these appear to be quite modest, the Company presents no real proposal to ensure customers actually receive any of these alleged benefits in a timely fashion. As noted above, the Commission has already expressed its view that ratepayers "should receive the benefit of a reduction in cost of capital . . . ."[13/] Avista's proposal completely fails on this score. Consequently, I see no basis for continuation of the ERM in its present form or acceptance of the Company's proposed changes to it.

[13/] WUTC Docket No. UE-050684, Order No. 4 at ¶91.

Q. DOES THE ERM DISTINGUISH BETWEEN COSTS CONTROLLABLE BY AVISTA AND THOSE THAT ARE NOT?

A. No, and this is yet another defect with the mechanism. As the Commission has already stated, "[t]he purpose [of a PCA] is to recognize variability in the cost of operating *existing* power supply resources as a result of abnormal weather conditions that are out of a utility's control."[14/] However, the ERM encompasses virtually all variable power supply costs, not just unexpected costs due to weather variations. While some of these costs are arguably outside the Company's control in the short run (hydro variations are the leading example), many costs are fixed by contract. For example, coal is usually purchased under long-term contracts, and many purchased power contracts have very long terms. To the extent such contracts include price escalations from time to time, the ERM really amounts to a "back door" rate increase. Rather than provide a revenue neutral sharing of costs between ratepayers and shareholders, in this case, the ERM really amounts to a process to grant recovery of utility cost increases in a lopsided manner.

Q. RETURNING TO THE PURPOSE OF THE ERM, CAN A TEMPORARY MECHANISM FAIRLY ALLOCATE RISKS BETWEEN THE COMPANY AND CUSTOMERS?

A. Not if the Commission were to allow the utility to "loosen" or even terminate the ERM in periods of good hydro or other favorable power cost situations but "tighten" it in "bad times." To be fair, the ERM should be in place long enough to encompass both up and down hydro cycles and other power cost circumstances so that "regression to the mean" can occur and the mechanism can approach revenue neutrality.

[14/] Id.

As described below, the OPUC recently adopted criteria governing an appropriate hydro-related PCA in Docket Nos. UE 165/UM 1187. Prior to adopting these criteria, the OPUC considered the issue of excess power cost recovery in a variety of cases since 2000, because Portland General Electric ("PGE") and PacifiCorp had requested approval of a number of different PCAs and deferred accounts to address below-normal hydro conditions and above-normal power prices. The OPUC's consideration of these power cost recovery issues culminated in its adopting generic criteria governing hydro-related PCAs. A copy of the OPUC's order in Docket Nos. UE 165/UM 1187 is attached as Exhibit No.___(RJF-3).

One of the primary criteria that the OPUC emphasized was that any PCA should be "revenue neutral" over time in order to ensure that neither the utility nor customers are enriched by the mechanism. The OPUC identified two important factors that relate to revenue neutrality. First, any PCA must be permanent or at least left in place on a long-term basis in order for conditions and cost fluctuations to balance out over time. Second, the OPUC recognized that an asymmetric deadband helps to ensure that a mechanism is revenue neutral if the utility at issue relies on hydropower to serve its load. Given that the cost of replacement power in poor hydro years will outweigh the savings of additional power in good hydro years, it is likely that customers will consistently be paying the Company for excess power costs without a commensurate opportunity to receive the benefits of cost reductions. Although ICNU is not proposing an asymmetric deadband in this case, this risk of asymmetric cost sharing is particularly relevant if a mechanism

has no deadband at all. These factors further support rejection of Avista's request to eliminate the deadband altogether.

Elimination of the ERM Deadband

Q. ASSUMING THE COMMISSION CONTINUES THE ERM IN SOME FORM, PLEASE COMMENT FURTHER ON AVISTA'S PROPOSAL TO ELIMINATE THE DEADBAND.

A. This would be a very unfavorable choice for consumers and clearly runs counter to the sentiments the Commission expressed in its order in Docket No. UE-050684. The primary support for Avista's proposal is that the $9 million deadband exposes the Company to substantial power cost risk and that eliminating the deadband would help improve the Company's credit rating. Mr. Gorman will address the credit rating aspects of this problem. However, the Company continues to exaggerate its susceptibility to power cost risks, as it did in Docket No. UE-050482.

Q. IS THERE ANY A PRIORI REASON TO ASSUME THAT THE $9 MILLION DEADBAND WILL BE DISADVANTAGEOUS FOR THE COMPANY?

A. No. Contrary to the implications of the Avista testimony, there is no reason to believe that the Commission understated power supply costs in Avista's recently completed rate case. Indeed, the Commission order granted nearly all of the Company's request, and in the end, adopted an amount that was virtually identical the level agreed upon by the Company in the stipulation. The Company also was allowed to update gas prices to $7.25 very late in the case, and gas prices appear now to be in that range.

Q. MR. PETERSON SUGGESTS THAT SMALL CHANGES IN GAS PRICES COULD CAUSE POWER COST VARIATIONS TO EXCEED THE DEADBAND. PLEASE COMMENT.

A. Mr. Peterson's observations are both irrelevant and wrong. As noted above, the Commission stated in Docket No. UE-050684 that the purpose of a PCA is primarily to address short-term cost variations due to weather and that deadbands are desirable because they fairly allocate costs between ratepayers and shareholder and motivate efficiency. Thus, sensitivity to gas price changes is not an appropriate basis for removing the deadband.

Further, Mr. Peterson exaggerates the impact of gas price changes on Avista's costs. Mr. Peterson testifies on page 8 that a $1 change in the price of natural gas equates to a $13 million increase in Avista's cost of fuel. However, this argument is misleading and erroneous because it ignores the fact that if gas prices increase, wholesale power prices will increase as well. In the Aurora run designed to implement the Coyote Springs 2 ("CS2") fuel adjustment in Docket No. UE-050482, gas prices were increased by 1.31/dth. However, Washington jurisdictional power costs increased by approximately $3.65 million, not $13 million.[15/] The power cost increase occurred because when gas prices increase for CS2, they also increase for all other suppliers in the wholesale market. Avista is a net seller in the market, thus, these higher prices offset most of the increase in the cost to run CS2. Consequently, this argument for eliminating the deadband is completely misleading, based on the Company's own Aurora study. While Mr. Peterson acknowledges that changing gas prices increase sales prices as well,

[15/] WUTC Docket No. UE-050482, Stipulation at Attachment A.

mitigating the increase in Avista's cost of fuel, he did not quantify this impact. As demonstrated above, the impact is quite substantial.

Q. WOULD HEDGING PROVIDE A REASONABLE WAY FOR THE COMPANY TO FULLY MITIGATE ITS POWER SUPPLY COST RISK VIS-À-VIS GAS PRICES?

A. Certainly. A successful hedging program could make gas a controllable expense for Avista. Mr. Peterson's example implies that the Company does not hedge any of its gas supply. If the Company were to hedge some of its supply it would reduce some of the risk of increased gas prices on the fuel costs for CS2. However, overall market prices, as discussed above, are not subject to constraint by such hedging. Thus, the Company should be able to find a "balance point" where the increase in market revenues from off-system sales is sufficient to equal the increased cost of a hedged gas supply. In this manner, the Company could essentially eliminate the risk of gas price increases, or at least reduce it to very manageable levels.

Q. HAS THE COMPANY ALSO EXAGGERATED ITS SUSCEPTIBILITY TO HYDRO VARIATIONS?

A. Yes. Both Mr. Peterson and Mr. Norwood testify that a 10% change in hydro generation would increase Washington jurisdictional costs by $18 million. Again, this contradicts the results of the Aurora model. Based on my analysis of Avista's own Aurora runs from Docket No. UE-050482, a 10% change in hydro would produce a $10 million change in Washington Jurisdictional power supply costs. Further, the Company did not consider the possibility of obtaining a "hydro hedge" to minimize its risk. PacifiCorp, for example, obtained a 5-year hydro hedge to reduce its hydro risk. While the PacifiCorp contract was confidential, it

did provide for payments to PacifiCorp in poor hydro conditions and receipts from that company when hydro was good. The Avista testimony exaggerates the significance of this problem suggests that the proposal to eliminate the deadband is supported by faulty analysis.

Q. WHATEVER THE SENSITIVITY TO HYDRO CONDITIONS OR GAS PRICES, IS ELIMINATING THE DEADBAND THE CORRECT POLICY FOR DEALING WITH VOLATILE POWER COSTS?

A. No. The Commission would be sending the Company exactly the wrong message by eliminating the deadband. In fact, it would be legitimizing a "victim" mentality that suggests the management of a utility is helpless to deal with changes in costs. It would suggest the management of the utility is nothing more than a bystander, completely at the mercy of the whims of the markets. The truth is just the opposite. Utilities have the long-term ability to select their resource mix. If gas is expensive and volatile, and hydro is unpredictable, coal or wind powered resources may be attractive options to diversify Avista's portfolio. However, by approving a mechanism that would assure full recovery of nearly all fuel and purchased power expenses, the Commission is giving the Company the incentive to do nothing. Rather than exploring for new resource options to balance its portfolio and manage its risk, the Company will know that it can simply make more withdrawals from the "ratepayer ATM." Consequently, the perceived risk of investment in new resources will likely be higher than the risk of volatile power supply costs. In the end, eliminating the ERM deadband will create a far greater obstacle to dealing with the problem of volatile power supply

costs because it will reduce the incentive of management to reduce risks for investors.

Q. HAVE OTHER CIRCUMSTANCES RELATED TO THE COMMISSION'S APPROVAL OF THE ERM CHANGED SINCE ADOPTION OF THE STIPULATION IN DOCKET NO. UE-011595?

A. Yes. During the power crisis and the settlement negotiations in Docket No. UE-011595, wholesale power costs appeared far more uncertain and volatile than today.

In addition, two of the elements of the Stipulation discussed above were the goal of "restoring the financial community's faith" in the Company and allowing Avista the opportunity to "turn its financial situation around." Avista's financial conditions have improved substantially. As Mr. Malquist testified in Docket No. UE-050482: "We have been aggressively rebuilding our financial health . . . ."[16/] In addition, the Company currently projects a return to investment grade status in 2007.[17/] Because bad and worsening financial conditions were part of the circumstances that resulted in adoption of the original $9.0 million deadband, the currently improving financial conditions support maintaining the deadband as it is.

Q. HAS THE COMMISSION MADE ANY COMMENTS IN OTHER CASES THAT HAVE A BEARING ON THE ISSUE OF THE ERM DEADBAND?

A. One of the strongest points the Commission made in its Order in UE-031725 (PSE's 2003 Power Cost Only Rate Case) was its view that ratepayers should not shoulder risks that are more appropriately borne by investors.[18/] Eliminating the

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16/ WUTC Docket No. UE-050482, Exh. No. 31 at 2:14-15 (Malquist).
17/ Exh. No.___(KON-1T) at 9.
18/ WUTC v. PSE, WUTC Docket No. UE-031725, Order No. 14 at ¶83 (May 13, 2004).

ERM deadband would increase the risks assigned to ratepayers and place more reliance on the prudence standard of cost recovery. Essentially, prudence would be the only major standard that the utility would have to meet in obtaining recovery of the great majority of its power supply costs. The Commission has already criticized over reliance on prudence as regards power cost matters in its Order in Docket No. UE-031725:

> All parties couch their arguments in terms of prudence, but the Company argues that prudence is independent of the various "benefit-caps" urged by the other parties to limit recovery. We think prudence matters, obviously, but is not dispositive on a stand-alone basis, either. Using prudence alone, at least as articulated by the Company in this instance, would completely sever the present from the past, giving no weight to the underlying reason and expectations around which the regulatory asset was created. The Company would have us look only at whether its decisions were prudent during the test period. If they were, then all costs would be allowed—gas costs, return of the regulatory asset, and return on the regulatory asset (all, however, subject to other mechanisms such as the PCA) regardless of whether the costs produce the benefits intended, or any benefits at all. This approach places too much risk on the ratepayers, under the specific facts of this case.[19/]

My reading of that passage is that, in regards to fuel and power supply cost matters, the Commission has stated that the prudence standard alone is not dispositive. The alternative to prudence (as discussed in paragraphs 84 and 85 of Order No. 14 in Docket No. UE-031725) is the used and useful standard, whereby investors assume the full risk associated with the decisions made by the managers they appoint. The Commission rejected sole reliance on the used and useful standard as well, but instead adopted a "hybrid approach." In my view, this "hybrid" approach would run counter to the proposal to eliminate the deadband.

[19/] Id.

Under the existing deadband and sharing mechanism, investors are at risk for $9.0 million in power supply costs in the event the Company failed to forecast those costs accurately, or to acquire power at prices low enough to meet their forecasts. Conversely, if the Company was successful, and enjoyed power supply costs less than projected, it would reap the first $9.0 million in benefit.

In proposing to eliminate the deadband, the Company now seeks to assign all of these additional power supply risks to ratepayers instead of shareholders. Naturally, the elimination of the deadband does not eliminate risk, it merely assigns the risk to ratepayers (who can do little or nothing about it) and takes it out of the hands of management (who have the duty to manage the Company along with the risks it faces).

Q. HAS THE COMMISSION ENDORSED DEADBANDS IN OTHER CASES INVOLVING AVISTA?

A. Yes. While not specifically identifying a deadband by name, in Docket No. UE-010395, the Commission certainly endorsed the concept of utility shareholders absorbing some power cost risks and sharing some of those risks with ratepayers:

> Within some reasonable bounds, it is appropriate that Avista's shareholders bear the risk of power costs that are higher than those implicit in Avista's rates. However, in light of the extraordinary volatility and unprecedented high prices in the wholesale power markets during 2000, and the first half of 2001, Avista's ratepayers may also need to share a portion of this risk. We find it is appropriate to take into account a market-risk factor as we weigh the evidence and determine an appropriate surcharge amount.[20/]

[20/] In re Avista, WUTC Docket No. UE-010395, Sixth Supp. Order at ¶74 (Sept. 24, 2001).

A deadband and sharing mechanism is an appropriate means for arranging this type of sharing. This illustrates that the Commission has consistently endorsed this concept.

III. ICNU's ERM PROPOSAL

Q. WHAT IS ICNU'S RECOMMENDATION FOR ADDRESSING THE PROBLEMS WITH THE ERM?

A. Rather than adopting ad hoc proposals for an ERM, the Commission should adopt generally applicable standards for such mechanisms. Earlier I discussed the principles that the Commission adopted for a proper PCA in the PacifiCorp rate case. These principles establish an appropriate framework for establishing generally applicable standards for evaluating the ERM and Avista's proposed modifications.

Q. WHAT CRITERIA DID THE OPUC ADOPT FOR EVALUATING POWER COST RECOVERY MECHANISMS IN DOCKET NOS. UE 165/UM 1187?

A. As I described above, the OPUC recently adopted the criteria identified in the order attached as Exhibit No.___(RJF-3) to determine an appropriate PCA related to variations in hydro conditions. Given that one of the criteria that the WUTC identified for a PCA is that it be "weather-related," the OPUC's decision may be informative as to how to design such a PCA to equitably balance weather-related risks between the utility and customers. The OPUC reached the following conclusions in UE 165/UM 1187:

- A PCA should be applicable only to unusual events (i.e., some power cost risk should be borne by the utility). This usually translates into some form of deadband.

- No PCA adjustment should occur if overall earnings are reasonable. In other words, offsetting cost savings or revenue increases should be considered before a utility is compensated for higher than expected power costs. This is known as the "double deadband" concept.

- PCAs should be revenue neutral over time, which may require asymmetric deadbands. As a result, deadbands should be designed to reflect the distribution of risk.

- PCAs should be permanent mechanisms to allow revenue neutrality to play out over time.

ICNU recommends that the Commission thoroughly review these criteria in the context of the WUTC's own framework for judging the reasonableness of a proposed PCA.

ICNU also recommends that the Commission consider PSE's current PCA, which includes a deadband and multiple sharing bands. In particular, the PSE PCA has a deadband, as well as a 50/50 sharing band.

Q. PLEASE DESCRIBE ICNU'S RECOMMENDED MODIFICATIONS TO THE ERM.

A. ICNU recommends the following changes to the ERM:

- The deadband should be reduced to $5 million.

- A new 50/50 sharing band should be established for deviations in excess of $5 million but less than $13 million.

- A new 90/10 deadband should be established for deviations in excess of $13 million.

- No power costs would be added to or subtracted from the deferral balance if equity earnings are within 100 basis points of Avista's last allowed rate of return or equity.

- The ERM should be adopted on a permanent basis to assure revenue neutrality. Absent extreme circumstances, the Commission should not modify the ERM for at least ten years.

- More definite procedural rules and minimum filing requirements should be implemented, along with provisions for periodic audits and reconciliation of revenues and costs collected under the ERM.

Q. PLEASE EXPLAIN THE PROPOSED CHANGES TO THE DEADBAND.

A. The reduction of the deadband to $5 million would serve to lower the threshold for relief for either the Company or customers and is a concession to reduce earnings volatility. However, by use of the 50/50 sharing of deviations between $5 and $13 million, the Company would still have the incentive to manage its power costs efficiently. This sharing is also consistent with the current PSE sharing mechanism approved by the Commission.

To further reduce Avista's risk, the sharing would go to 90/10 after power costs deviations exceed $13 million. This would provide substantial relief in circumstances where power cost variations become large.

Q. EXPLAIN THE BASIS FOR THE ROE DEADBAND.

A. This requirement would eliminate the possibility of providing the Company with additional power cost recovery when its overall earnings are adequate or requiring the Company to provide ratepayers a credit for cost savings when the Company's earnings are inadequate. The OPUC endorsed this feature in the PGE order in UE 165/UM 1187, as discussed above.

Q. DISCUSS THE OTHER REQUIREMENTS PROPOSED BY ICNU.

A. To ensure revenue neutrality, the Commission should require any automatic adjustment clause to remain in effect unchanged for a long period of time. If the parameters of the ERM are allowed to change over time, it is quite likely the Company will attempt to persuade future Commissions to change the ERM when

it would be advantageous for the Company to do so. Consequently, in good hydro cycles, it is likely the Company might propose to broaden the deadband, just as it now proposes to narrow the deadband after a number of poor hydro years.

In addition, the Commission should implement detailed rules and minimum filing requirements for the ERM from this case forward. Past experience shows that the time for review is too limited, and the workpapers filed by the Company are not adequate for a comprehensive review and audit. As a result, ICNU recommends the Commission convene a rulemaking proceeding and design minimum filing requirements applicable to future cases.

Finally, Mr. Gorman discusses the need for the Commission to implement additional measures if it reduces or eliminates the ERM deadband. First, Mr. Gorman recommends that the Commission recognize the decrease in Avista's cost of debt that is expected to occur in 2007 and 2008, and record the amount of the cost reductions in a deferred account in order to reduce the power cost deferral balance. Second, Mr. Gorman states that the Commission should require Avista to demonstrate that the Company has implemented a prudent hedging strategy.

Common Cost Allocation

Q. ASSUMING THE COMMISSION RETAINS THE ERM, DO YOU AGREE WITH THE COMPANY'S PROPOSAL TO EXCLUDE COMMON COSTS FROM THE POWER PRODUCTION FACTOR?

A. No. These costs originally were included in the ERM to avoid the problem of double recovery of production costs when sales are growing. Conversely, in cases when sales are decreasing, it eliminates the problem of under recovery. Because common costs are part of the overall cost of service that are recovered on the

basis of volumetric (rather than customer) charges, they should be included in the ERM power production factor.

Alternatives to the ERM

Q. IN DOCKET NO. UE-050684 THE COMMISSION HELD THAT THE PURPOSE OF A PCA WAS TO DEAL WITH SHORT-TERM COST VARIATIONS DUE TO ABNORMAL WEATHER. HYDRO UNCERTAINTY IS PROBABLY AVISTA'S MOST SUBSTANTIAL SOURCE OF WEATHER-RELATED POWER COST VARIATION. ASSUMING THE COMMISSION WISHES TO IMPLEMENT A MECHANISM TO ADDRESS THIS PROBLEM RATHER THAN CONTINUING THE BROADER-BASED ERM, DO YOU HAVE A PROPOSAL?

A. Yes. In that case, I would recommend implementation of a "hydro hedge tariff" to simulate a hypothetical hedge agreement between Avista and its ratepayers. The concept is that ratepayers would be the counterparty to a hedge (much like Aquila was for PacifiCorp in their hedge arrangement).

Under this proposal, ratepayers would compensate Avista for a specific dollar amount in the event of poor hydro conditions. The hedge would only be implemented if hydro conditions substantially departed from normal or average conditions. For example, if hydro conditions were in the 20th percentile (i.e., 80% of all expected hydro conditions would be better), ratepayers would pay the Company (via the tariff) an amount equal to the expected cost of replacement energy based on Aurora model runs used in Avista's most recent general rate case. Likewise, when hydro conditions were in the 80th percentile (i.e., more water than 80% of all expected hydro conditions) then ratepayers would be paid via a credit in the tariff. Because Aurora simulates the change in market prices resulting from changes in hydro conditions, it is possible to develop a hydro

hedge that reflects not only the variances in hydro output, but also associated changes in market prices. However, if the Commission adopts this proposal, I recommend it limit the tariff so that it only applies in extraordinary hydro conditions, and that the Commission require the Company to pay ratepayers a "premium" for being the counter party in this hedge with the Company.

Q. IS A PREMIUM OF THIS SORT A REASONABLE FEATURE OF THIS HYPOTHETICAL "HYDRO HEDGE" TARIFF?

A. Certainly. Avista would normally expect to pay a counterparty to enter into a hedge. For example, PacifiCorp paid Aquila $1.75 million per year as a premium to enter into a hydro hedge over the past several years. I see no reason why ratepayers should assume the risks of a hedge arrangement but not be afforded a fair premium for doing so.

Q. DESCRIBE THE STATISTICAL ANALYSIS OF AVISTA'S HYDRO GENERATION AND POWER COSTS YOU HAVE PERFORMED TO ILLUSTRATE THE WORKINGS OF THE HYDRO HEDGE TARIFF.

A. Exhibit No.___(RJF-4) shows the analysis underlying the hydro hedge tariff. The hydro data was taken from the information supplied in the Aurora model used in Docket No. UE-050482. The power cost data was taken from the Company's output file for its 60 water year run (1929-1988) from the prior case, not from any new Aurora runs. I eliminated the years not used in the Commission's final order (1979-1988) to provide power cost results for each of the 50 water years used in the study.

The exhibit shows that Avista's mean hydro generation for the period used in the rate case was 506.4 average MW. The standard deviation is 83.8 average

MW. For power costs, the mean was $90.3 million, and the standard deviation was $27.1 million.

I propose that the hydro hedge would not result in any payments of credits (other than the premium) if hydro conditions remained one standard deviation or less from the mean. The exhibit illustrates the payments and credits that would result if this approach were used. The exhibit also assumes a hydro hedge premium of $1.0 million to ratepayers. This is comparable to, but less than, the amount paid by PacifiCorp.

Case 1 assumes that the hedge would result in additional payments or credits if hydro generation was one or more standard deviations from the mean. In this case, customers would have an additional credit or payment of approximately $17 million before the hedge was triggered. In effect, this approach would provide a $17 million deadband.

In Case 2, the hedge is designed to provide an effective deadband of approximately $9 million to be comparable to the current ERM. In this case, the additional hedge payments and credits would be triggered when hydro departs from mean conditions by about 37 MW or more.

Q. WHAT ARE THE ADVANTAGES OF THIS APPROACH?

A. First, it addresses only costs related to short-term weather variations, which are not controllable by the Company. This was one of the guiding principles stated by the Commission in the recent PacifiCorp case. This approach defines up front the level of risks assumed by customers and limits them to known amounts. Risks are limited to hydro variations, which we all agree are beyond Avista's control.

Under an ERM, there is virtually no limit to the amount and scope of risk that ratepayers assume. I believe it is very unlikely that Avista could find a counterparty that would hedge unlimited risks and risks of virtually any kind. Ratepayers should not be required to provide a hedge completely out of line with what is available in the commercial market.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.