

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION

In re the Matter of)	DOCKET NO. UE-011514
)	
AVISTA CORPORATION d/b/a)	
AVISTA UTILITIES)	
)	
For an Order Finding Avista's Deferred)	
Power Costs Were Prudently Incurred)	
and Are Recoverable)	
)	
.....)	
WASHINGTON UTILITIES AND)	
TRANSPORTATION COMMISSION)	
)	
)	DOCKET NO. UE-011595
)	
Complainant,)	
)	
v.)	
)	
AVISTA CORPORATION d/b/a)	MEMORANDUM OF
AVISTA UTILITIES)	COMMISSION STAFF IN
)	EXPLANATION OF
Respondent.)	SETTLEMENT STIPULATION
)	
.....)	

This memorandum is provided to assist the Commission in understanding the Settlement Stipulation filed by the parties on February 21, 2002. This memorandum is permitted by Paragraph III.3 of the Settlement Stipulation. It focuses on Part II of that document, in which the Parties set out the substantive provisions of the proposed settlement.

As noted on page 2 of the Settlement Stipulation, the proposed settlement is subject to Commission approval. A Commission hearing on the matter is set for Monday, February 25, 2002.

I. Background and Overview

Avista accrued over \$200 million in power costs from July 2000 through December 2001, to Account 186, Misc. Deferred Debits per the Commission's accounting orders in Docket No. UE-000972.

In Docket No. UE-010395, the Commission approved a 25% surcharge, the revenues from which are to be used to offset these deferred power costs. That surcharge was effective October 1, 2001. It is subject to refund.

On November 13, 2001, in Docket No. UE-011514, Avista filed a petition for a Commission order confirming the prudence of the deferred power costs and declaring the deferred power costs are recoverable in rates.

On December 3, 2001, in Docket No. UE-011595, Avista filed a general rate case which included a request for a 12.4% interim increase in rates above the existing base rate levels. Avista requested any interim rate relief be subject to refund.

The substantial uncertainty that the deferral balances pose for Avista is a matter of concern to lenders, rating agencies, the Commission and ultimately, the ratepayers. On October 10, 2001, Standard & Poor's lowered Avista's corporate credit rating to "BB+" from "BBB-". Other rating agencies took similar actions. Avista's credit rating is now below "investment grade." The Company's substantial deferred power costs, the lack of certainty as to their recovery, and the potential for refunds were cited as justification for the downgrades. Consequently, Avista was required to pay higher interest rates on some

existing debt, to post security to maintain previously unsecured debt, and to pay higher fees to keep credit lines open. Many lenders, such as pension funds or insurance companies, have restrictions on how much money they will lend to corporations which are rated below investment grade. Avista's options for sources of money are now more constrained than before the downgrades.

Avista's main source of funds to finance power purchases and the Coyote Springs II Project is its revolving credit line and other short term lines of credit. Avista needs to refinance \$310 million in short term credit lines by the end of May this year. In order for the Company to complete this substantial refinancing on reasonable terms, or perhaps at all, it requires additional revenue to improve debt coverage ratios, and it needs to reduce the level of debt on its balance sheet. Avista must also show lenders that the deferred power costs will be reflected in rates.

Avista seeks resolution of these issues in Docket No. UE-011514 (the prudence and recoverability of Avista's power costs accrued through September 30, 2001) and in Docket No. UE-011595 (Avista's filing for a general rate increase and request for interim rate relief).

In general terms, the Settlement Stipulation, if accepted, resolves all of the issues in Docket No. UE-011514, and certain important issues in Docket No. UE-011595. Such resolution provides certainty to Avista in a manner all parties agree is in the public interest. We address the specifics below.

II. Description of the Settlement Stipulation and Staff's Review

A. Stipulation Paragraph II.1: Recoverability of Deferred Costs

Settlement Stipulation Paragraph II.1 states that 90% of the power costs accrued through December 31, 2001, are recoverable in rates. This amount is approximately \$196 million. Avista must book the remaining 10% of the deferred power costs to expenses according to proper accounting practices. This amount is approximately \$21.8 million, or about \$.30 per share.

Docket No. UE-011514 specifically addresses the recoverable level of power costs accrued through September 30, 2001, approximately \$198.5 million per Avista's request. The Settlement Stipulation resolves the recoverability of accrued power costs not only through September 30, 2001, but also for an additional period: October 1, 2001 through December 31, 2001. While this latter period is not at issue in Docket UE-011514, it is at issue in Docket No. UE-011595, and is an important consideration with respect to interim rate relief. The agreement to settle the deferred power costs through the fourth quarter of 2001 affords Avista the benefit of filing "clean" financial reports for all of 2001, eliminating the uncertainty of further adjustments to those reports.

The deferred power costs from July 2000 through December 2001 total \$217,803,712. The parties to the Settlement Stipulation agree that \$196,023,342 of that total is recoverable.

The Commission stated that the issues to be examined in Docket No. UE-011514 (commonly termed the "prudence case") include, but are not limited to: a) the prudence of the power cost incurred or to be incurred by the Company; b) the optimization of Company-owned resources to the benefit of its retail customers; c) the appropriateness of

recovery of costs through a deferral mechanism; and, d) a proposal for cost of capital offsets to recognize any shift in risk to ratepayers. Staff (and we believe other parties as well) gave these issues a thorough examination. Staff is prepared to respond to Commissioner questions regarding Staff's review of the accrued power costs at the hearing on this Settlement Stipulation.

Staff's evaluation in this proceeding began with the deferral balances as of September 30, 2001, of nearly \$200 million. As discussed above, under the Settlement Stipulation, the parties extended that evaluation to those specific costs the Company has included in the deferral balance up to December 31, 2001.

Staff reviewed the Commission's prudence standards and considered factors unique to this proceeding. Staff evaluated a series of decisions involving well over a thousand individual power transactions, together adding up to many millions of dollars. This differed from previous prudence proceedings where a much smaller number of large resource acquisitions were at issue. As one would expect, each of those acquisitions were more extensively documented.

As part of its analysis in Docket No. UE-011514, Staff sampled transactions at Avista Utility and compared these to similar contemporaneous transactions at Avista Energy. Staff concluded that these numerous, but relatively small market transactions were adequately supported.

Staff also reviewed the Company's overall resource position at the beginning of the deferral period and the resource decisions and transactions made by the Company during the deferral period. During the deferral period, Avista made numerous short-term resource operation decisions such as altering maintenance schedules, temporary resource

acquisition decisions such as the Kettle Falls Bi-fuel Project, forward sales and purchase transactions, short-term sales and purchase transactions, certain gas acquisition transactions, as well as other efforts to mitigate the cost effects of poor hydro conditions and the high wholesale electric market prices. Staff concluded that Avista's actions with respect to its overall resource position were appropriate.

Staff also evaluated the remaining issues identified in the Commission's Second Supplemental Order—specifically, the appropriateness of recovery of costs through a deferral mechanism, and a proposal for cost of capital offsets to recognize any shift in risk to ratepayers. Staff also considered the fact that the actions and decisions of the Company that resulted in the deferred cost balances involve risk. Risk should appropriately be shared between both the ratepayers and the Company. The Commission stated this principle in its Sixth Supplemental Order in Docket No. UE-010395, at ¶¶ 73 and 74. In Staff's view, the Settlement Stipulation reflects an appropriate application of these principles to resolve the level of sharing between the Company and ratepayers, and to resolve the issues of prudence and recoverability in a fair manner.

B. Stipulation Paragraph II.2: Resolution of Other Issues

Paragraph II.2 of the Settlement Stipulation resolves Avista's request in Docket No. UE-011595 for a 12.4% interim rate increase, subject to refund. The Settlement Stipulation calls for a 6.2% increase over base rates, with no refund condition imposed. In addition, of the 25% surcharge currently being collected, Avista would be authorized

to apply 20% to deferred power costs, and book 5% as operating revenues to offset general operating costs.¹

The 6.2% increase serves to improve Avista's cash flow and earnings, and consequently it improves Avista's coverage ratios and other financial ratios. These ratios are of concern to lenders and rating agencies, and are the basis of many of the covenants in Avista's debt obligations. The 5% from the 25% surcharge does not, of itself, improve cash flow since it is already being collected, but it does improve Avista's earnings, as well as its debt ratio, which is at or near the 60% maximum debt level contained in certain Avista bond covenants.

The Settlement Stipulation proposes that the 6.2% increase in base rates is permanent and not subject to refund.² The Company-proposed refund condition imposes unnecessary uncertainty. Staff believes the removal of regulatory uncertainty will facilitate Avista's ability to renew the short term credit lines that expire this Spring. In the pending general rate case, the Commission will determine the appropriate overall revenue level for Avista, and the appropriate rate levels going forward. By allowing a permanent 6.2% increase in base rates now, the revenue requirement increase in the general rate case is reduced commensurately. The Company's revenue requirements and resulting rates will be determined in the pending general rate case.

¹ Staff estimates that the impact of changing the amount of the current 25% surcharge that is applied to deferral balances from the full 25% to 20% would be to extend the amortization period about two months. This estimate assumes: a) the deferral balances are those stated in the Settlement Stipulation; b) the full 25 percent surcharge stays in place; c) the carrying charge interest rate remains as proposed; and d) as of October 2002 (i.e. at the conclusion of the general rate case), the full 25% resumes being credited to those deferral balances.

² This is consistent with virtually every "true" interim rate relief case decided by the Commission. Only two exceptions were found: *Washington Utilities & Transp. Comm'n v. Washington Natural Gas Co.*, Cause No. U-80-111, (Second Supp. Order at 8, Ordering paragraph 5)(1981), and more recently, in *Washington Utilities & Transp. Comm'n v. Olympic Pipe Line Co.*, Docket No. TO-011472.

The specific level of a surcharge, and the manner of recovering the deferred power costs in general, is an issue to be resolved in the general rate case. For example, if the current (i.e. post-December 31, 2001) deferrals result in a net credit, the Commission retains discretion to use any such credit to offset the deferral balance contained in the Settlement Stipulation.

Both Staff's and Avista's projections of financial ratios show that under any scenario, it will take time for Avista to return to financial health. It is also important to recognize that Avista's own projections assume Avista will be able to receive \$50 million in dividends from Avista Energy in 2002, in order to support its fixed charge ratio and capitalization ratio. Avista Corp. continues its efforts to receive permission from Avista Energy's lenders to allow cash dividends from the subsidiary to be released to the parent company.

C. Stipulation Paragraph II.3: Adjustment of 2002 Deferrals

Avista agrees to remove from the 2002 deferred power costs the capital cost and non-fuel operating costs of the new power projects Coyote Springs II, Boulder Park, and Kettle Falls CT. This has the effect of reducing the deferred power costs that will be at issue in the pending general rate case, providing a future benefit to ratepayers.

Removing the capital costs and non-fuel operating and maintenance costs from the deferral balance addresses a point of contention regarding what costs were appropriately deferred. This paragraph of the Stipulation does not imply in any way that Company-owned resources such as Coyote Springs II will not be eligible for inclusion in rate base.

D. Stipulation Paragraph II.4: Cost of Capital

The parties were able to agree that the cost of capital decided in the last general rate case should form the basis for the cost of capital determination in Docket No. UE-011595. The parties agreed to the same capital structure, and to update the cost of debt and the cost of preferred equity for known and measurable changes. The cost of common equity would stay the same as in the last general rate case, except the parties could present arguments on how a power cost adjustment mechanism affects the cost of common equity.

Resolving these cost of capital issues provides certainty to Avista, significantly reduces litigation burdens on all parties and the Commission, and reaches a fair and sufficient result.

E. Stipulation Paragraph II.5: Good Faith Negotiations Over Remaining Issues in the General Rate Case

The parties reached this Settlement Stipulation based on good faith negotiations. Staff's general view is that this can continue and other issues in the general rate case can be positively discussed and fruitfully addressed. In particular, the issue of a power cost adjustment or similar mechanism will benefit from the collaborative efforts of the parties. This paragraph of the Stipulation does not promise results, but it does promise cooperative efforts. Any resolution of any issue that results from this process would be subject to Commission review and approval.

F. Stipulation Paragraph II.6: Implementation of Certain Customer Impact Mitigation Measures

The Settlement Stipulation addresses the concern that customers have been, and continue to be seriously impacted by the 25% surcharge, and they will be further impacted by the 6.2% increase proposed in the Settlement Stipulation. The Settlement Stipulation contains specific measures to address this concern, while taking into account Avista's financial condition.

The measures Avista agrees to execute include extending the Winter Low Income Payment Program, promoting the Company's levelized billing program (with broadened eligibility conditions), offering additional alternative deposit options, enhancing customer service representatives awareness of the CARES program, and promoting additional donations to Project Share. The CARES program and Project Share provide direct assistance to those customers most in need.

While none of these measures are believed to have a significant revenue or cost impact on the Company, they will serve those customers least able to cope with the rate changes at issue here.

The customer impact measures that are contained in the Settlement Stipulation are proposed to last until the Commission's order in the pending general rate case. But they could be extended by the Commission if the Commission decides that is appropriate in its order in the pending general rate case.

III. Conclusion

Based on its review of the transactions at issue in the proceeding and the ultimate recoverability of Avista's deferred power costs, Staff is satisfied that the recoverability of deferred power costs called for by the Settlement Stipulation is reasonable. The proposed

settlement resolves the uncertainty surrounding the recovery of these deferral balances in a manner that recognizes a sharing of risk between shareholders and ratepayers.

The 6.4% rate increase agreed to by the parties, in conjunction with the proposal to apply a portion of the previously authorized deferral-recovery surcharge to general operating revenues, improves the Company's financial situation to the degree necessary for the Company to renegotiate short term credit lines that expire this Spring. Avista needs these credit lines to finance its power purchases and its Coyote Springs II Project.

The agreement seeks to minimize the impact on customers of the interim rate increase in two general ways: by reducing the amount of interim relief sought by the Company and instead reapplying a portion of the surcharge to improve earnings, and by obtaining the Company's commitment to important, but not costly, measures to mitigate the impact of this rate increase on the Company's most vulnerable customers.

Finally, the provisions to remove certain costs for deferral during 2002, and to define the method for determining cost of capital in the pending general rate case, provide certainty and resolve potentially contentious issues that would otherwise have to be taken up by the Commission in that proceeding.

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For all of the foregoing reasons, Staff believes the proposed Settlement Stipulation is in the public interest and recommends that it should be accepted by the Commission.

DATED this 22nd day of February, 2002.

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Washington Utilities and
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