BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NOS. UE-050482 and UG-050483

REBUTTAL TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

Q. Please state your name, employer and business address.

A. My name is Kelly O. Norwood. I am employed by Avista Corporation as the Vice-President of State and Federal Regulation.

Q. Have you previously filed testimony in this proceeding?

A. Yes. I co-sponsored testimony in this proceeding on August 26th, describing and supporting the Settlement Agreement filed on August 12th.

Q. What is the scope of your rebuttal testimony?

A. I will provide an overview of the Company's response to the direct testimony of Public Counsel and the Industrial Customers of Northwest Utilities (ICNU). Together with other Company witnesses, I will show, that after accepting certain adjustments that have been identified through the discovery process, settlement discussions, and review of Public Counsel's and ICNU's testimony, the Company has revised its electric litigation case from $35.8 million to $33.4 million. The Company's natural gas litigation case is revised from $2.9 million to $2.6 million.

Accordingly, the Settlement Agreement, with an electric revenue increase of $22.1 million and a natural gas increase of $968,000, represents a reasonable compromise, is supported by the record, is consistent with the public interest, and should be approved by the Commission.

Q. Do you have any general comments related to the testimony presented by Public Counsel and ICNU?

A. Yes. Public Counsel presents four witnesses. James R. Dittmer summarizes Public Counsel's recommended $11,733,000 electric and $218,000 natural gas rate increases, as well as a number of proposed adjustments. Merton R. Lott provides testimony related to certain power supply costs and the Energy Recovery Mechanism. Stephen G. Hill, as Public Counsel's cost of capital witness, recommends an overall rate of return of 8.64% based on a return on equity of 9.25% with a common equity component of 40%. Jim Lazar discusses modifications to the Company's cost of service methodology, and presents Public Counsel's rate spread and rate design proposals.

Randall J. Falkenberg, the first of two ICNU witnesses, addresses the Company's Aurora model study and proposes adjustments that would reduce Avista's power supply costs by approximately $14 million. He also recommends, among other things, that the Energy Recovery Mechanism be terminated. ICNU's cost of capital witness, Michael Gorman, proposes a return on equity of 9.8%. Mr. Gorman did not specifically identify an overall rate of return, and neither witness provided an overall electric revenue increase recommendation.

The Company will show in its rebuttal testimony that the vast majority of the adjustments proposed by Public Counsel and ICNU are not supported by sound evidence and analysis. For example, the costs that Mr. Lott is proposing to address through his proposed Production Property Adjustment are already addressed in the existing Retail Revenue Credit calculation in the ERM. I will demonstrate later in my testimony that the addition of Mr. Lott's Production Factor Adjustment would actually adjust for these costs a second time.

A further example is Public Counsel's return on equity (ROE) recommendation. Although there are financial theories and calculations that one could use to arrive at a 9.25% ROE recommendation (or, indeed, a much higher number), in reality, the financial community and investors expect, and require, a much higher authorized ROE in this case. As already explained in other testimony in this case, Regulatory Research Associates (RRA), in its Regulatory Focus publication dated July 6, 2005, reported that the average ROE authorized by state commissions nationwide for the first six months of 2005 was 10.36% for electric utilities (based on 16 rate cases), and 10.56% for natural gas utilities (based on 8 rate cases). The 10.4% ROE included in the Settlement Agreement falls well within the reported averages.

Adoption of Public Counsel's 9.25% ROE recommendation would alarm the financial community and make it more difficult for Avista to attract capital on reasonable terms, in order to invest in the infrastructure necessary to serve its customers.

Q. By eliminating the double-counting that occurs with Mr. Lott's Production Property Adjustment and revising the ROE to a more reasonable level, such as the 10.4% in the Settlement Agreement, what effect would that have on Public Counsel's revenue increase recommendation of $11.7 million?

A. Elimination of the Production Property Adjustment proposed by Mr. Lott increases the Company's revenue requirement by $2.4 million.[1] Changing the ROE from 9.25% to 10.40% increases the revenue requirement by $5.9 million. These <u>two</u> adjustments alone total $8.3 million, and would increase Public Counsel's revenue increase level from $11.7 million to $20.0 million, as compared to the proposed Settlement Agreement increase of $22.1 million. This $20.0 million is prior to consideration of extensive rebuttal provided by Avista on a host of other adjustments proposed by Public Counsel that are not reasonable. Acceptance of even a portion of the Company's rebuttal of these issues would result in a revenue increase to Avista that is well above the $22.1 million that the Company has agreed to accept in the Settlement

[1] This includes adjustments to rate base, depreciation and the effects of proforma debt interest (interest synchronization).

Agreement.

Q. Do you have any general comments related to the power supply adjustments proposed by Mr. Falkenberg, representing ICNU?

A. Yes. Mr. Kalich explains in his testimony that Mr. Falkenberg has identified an error in the way the maintenance for the Colstrip coal-fired units was included in the Aurora model. Mr. Kalich has made this correction, which decreases the Company's original revenue requirement of $35.8 million by $481,000.

Mr. Falkenberg's other proposed adjustments, however, are not supported by sound evidence and/or analysis, and should not be accepted by the Commission. Mr. Kalich will address each of these proposed adjustments in his rebuttal testimony.

II. REVISIONS TO AVISTA'S ORIGINAL FILING

Q. Does the Company have any revisions to make to its original filing, following the extensive discovery that has occurred to date, negotiation of the Settlement Agreement, and after review of Public Counsel's and INCU's testimony?

A. Yes. After completing the discovery to date, the settlement discussions, and a review of Public Counsel's and ICNU's testimony, the Company agrees there are certain adjustments that are appropriate to make to its original filing. The original filing, as adjusted, would represent the Company's litigation position, were the Settlement to be rejected, and this matter fully litigated.

In its original filing, Avista requested an electric revenue increase of $35,833,000 and a natural gas increase of $2,943,000. The adjustments that the Company agrees to make to its original filing are identified below. A brief explanation of each of these adjustments is provided in Exhibit No. ___ (KON-2).

Revisions to Avista's Original Filing

	Increase/(Decrease) in Avista Case	
	Electric	Natural Gas
Avista Original Filing	**$35,833,000**	**$2,943,000**
Adjustments:		
1. Colstrip AFUDC	(57,000)	
2. Colstrip Common AFUDC	8,000	
3. Colstrip Maintenance	(504,000)	
4. Cancellation of Small Generation	(161,000)	
5. Kettle Falls Fuel Costs	828,000	
6. CS 2 Gas Transportation	(3,296,000)	
7. Coyote Springs 2 Fuel	3,818,000	
8. Misc. Power Supply Adjustments	(564,000)	
9. Wheeling Revenue	(1,167,000)	
10. Gain on Sale of Property	(61,000)	(13,000)
11. Misc. Accounting Adjustments	(103,000)	(48,000)
12. Software Leases	(1,141,000)	(318,000)
Avista Revised Case[2]	**$33,433,000**	**$2,564,000**

Therefore, if the Settlement Agreement were to be rejected and this matter fully litigated, Avista's electric and natural gas revenue requirements would be $33.4 million and $2.6 million, respectively. The agreed-upon revenue requirement of $22.1 million for electric and $968,000 for natural gas, as set forth in the Settlement, represents a substantial reduction from Avista's litigation position.

[2] Avista's electric rate base is reduced from $795,845 to $795,467. (Colstrip AFUDC –$441 and Colstrip Common AFUDC +$63.) Avista's natural gas rate base is unchanged at $130,718.

III. AVISTA REBUTTAL WITNESSES

Q. Please identify the Company's rebuttal witnesses and briefly summarize their testimony.

A. The following additional witnesses are presenting rebuttal testimony on behalf of Avista.

Dr. William E. Avera, President of Financial Concepts and Applications (FINCAP), Inc., responds to the direct testimony of Public Counsel's and ICNU's cost of capital witnesses. Dr. Avera concludes that a Return on Equity in excess of 11% and a 44% common equity component is justified. The agreed-upon cost of capital in the Settlement, based on a Return on Equity of 10.4% and an equity portion of the capital structure at 40% on, is well below what the Company believes the evidence would still support.

Mr. Don Falkner, Manager of Revenue Requirements, addresses specific accounting adjustments proposed by Public Counsel and ICNU. He supports adjustments contained in the Company's original filing, such as the accounting treatment of customer deposits, Kettle Falls Generating Station, vegetation management, the California property sale, and tax issues. He also identifies the adjustments proposed by Public Counsel that the Company would be willing to adopt for purposes of this case, and addresses other proposed adjustments with which the Company does not agree.

Mr. Clint Kalich, Manager Resource Planning and Power Supply Analyses, addresses the power supply related adjustments proposed by Mr. Randy Falkenberg testifying on behalf of ICNU. Mr. Kalich demonstrates that the AURORA model properly reflects the true system dispatch of Avista's generation resources and contracts. He explains why Mr. Falkenberg's proposals related to the 40-year hydro study, Colstrip upgrades, plant maintenance assumptions and bidding factors should not be accepted.

Mr. William Johnson, Senior Power Supply Analyst, responds to adjustments proposed by witnesses Lott and Falkenberg related to the test period power supply revenues and expenses.

Mr. Randy Cloward, Director of Engineering and System Operations, responds to the testimony of Public Counsel's Merton Lott related to his proposed adjustments to "OASIS Revenues" and other transmission expenses.

Ms. Tara Knox, Rate Analyst, responds to the cost of service testimony of Public Counsel. She shows that the results of the Company study are reasonable and provide a sound basis for the Company's proposed rate spread recommendations.

Mr. Brian Hirschkorn, Manager of Retail Pricing, responds to Mr. Lazar's proposed spread of the overall electric increase among the Company's rate schedules, as well as Mr. Lazar's proposed residential rate design. More specifically, he discusses why Mr. Lazar's recommendations regarding electric rate spread and rate design should not be accepted.

IV. REBUTTAL OF PUBLIC COUNSEL'S POWER SUPPLY ADJUSTMENTS

A. Production Property Adjustment

Q. Earlier in your testimony you stated that the Production Property Adjustment proposed by Mr. Lott should not be accepted. Please explain why.

A. The costs that Mr. Lott is intending to address with his Production Property Adjustment are already being adjusted through the existing ERM calculations. I will provide a summary explanation of how these costs are already accounted for, and Company witness Mr. Johnson will provide more detailed examples and analyses.

Q. What is the real issue Mr. Lott is proposing to address with his Production Property Adjustment?

A. Mr. Lott is concerned that production property costs, i.e., generally the costs associated with owning and operating Avista's generating projects, will be over-collected by the Company as retail loads grow in the future.

In this general rate case, as in previous general rate cases, the retail load used to set retail rates is based on the actual 2004 (test year) kilowatt-hour (kWh) sales, with certain adjustments. The sales for the calendar year 2004 are adjusted to reflect normal temperature conditions, and also to reflect any known changes to the number of customers or to their usage, such as new sales to a new industrial customer. Thus, retail sales are based on the historical 2004 sales, as adjusted.

Power supply costs in this case, including production property costs, are adjusted to reflect the costs that the Company expects to experience at the time that new rates go into effect, beginning in 2006.

In essence, the expected 2006 production costs are divided by 2004 retail loads to determine the retail rates that customers pay. Mr. Lott's theory is that as retail loads grow, i.e., from 2004 to 2006, the Company will over-recover its production costs because the production costs are already covered by the lower 2004 loads.

In order to adjust for this theoretical over-collection, Mr. Lott ratchets down the 2006 production costs by the ratio of estimated 2006 retail loads to the 2004 retail loads. In his testimony Mr. Lott suggests that loads will grow by a total of 4.24% from 2004 to 2006 (2.1% per year), and in his Production Property adjustment he reduces production rate base by 4.24% or $15.0 million.

If there were no offsetting adjustments, Mr. Lott would be correct. However, there is clearly an offsetting adjustment that Mr. Lott has overlooked.

Q. Please explain.

A. In the existing Energy Recovery Mechanism there is an adjustment that is referred to as the Retail Revenue Credit. This Retail Revenue Credit (RRC) adjustment is designed to deal with the very issue that Mr. Lott has raised in his Production Property discussion.

I will use a simple example to illustrate how the RRC ensures that the Company does not over-collect production costs. The illustration assumes that new retail rates are approved effective January 1, 2006 based on 2004 loads, as explained earlier.

In the RRC calculation for January 2006, the actual retail loads (sales) for January 2006 are compared with the retail loads for January 2004 that were used to set base retail rates.[3] If the January 2006 loads are higher than January 2004 loads, the increased kWh sales are multiplied by the cost of production, and the resulting dollar amount is credited back to customers in the ERM. This credit reduces the cost of power charged to retail customers, and ensures that Avista does not over-collect its production costs due to growth in retail loads. This adjustment occurs every month in the ERM.

The cost of production used in the Retail Revenue Credit calculation is based on the 2006 production costs in the cost of service study used to establish base retail rates in the first place.[4] Therefore, to the extent that retail loads grow over time, the additional production costs collected

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[3] The change in loads could be due to customer growth, change in use per customer, differences in weather conditions, price elasticity, etc.

[4] Avista witness Tara Knox provides direct testimony and rebuttal testimony related to the cost of production used in the Retail Revenue Credit calculation.

by Avista will be credited back to all customers through the ERM, thereby eliminating any over-recovery of production costs.

Furthermore, the production cost credit to customers is based on actual load growth over time, instead of the load growth estimates from the IRP that Mr. Lott proposes be used in his adjustment. Therefore, the existing Retail Revenue Credit adjustment would provide a more accurate calculation of the production cost adjustment.

Mr. Johnson notes in his testimony that the Retail Revenue Credit for 2003 and 2004 were \$2.1 million and \$3.7 million, respectively. The average of the two years is \$2.9 million, as compared to the \$2.4 adjustment to revenue requirement proposed by Mr. Lott through his Production Property Adjustment. Therefore, the Retail Revenue Credit production cost adjustment already in place in the ERM, on an actual basis, has been greater than that proposed by Mr. Lott.

In summary, there is an adjustment already in place for the very costs Mr. Lott is concerned about. In addition, the Retail Revenue Credit is based on actual load growth, rather than the estimated load growth Mr. Lott would use in his adjustment, and therefore, is a more accurate adjustment. Mr. Lott's Production Property Adjustment should be rejected.

Q. On page 18 of his testimony, Mr. Lott states that a Production Property Adjustment has been used for many years in Puget Sound Energy (PSE) rate cases. Does that suggest that a similar adjustment should be used in this case?

A. No. In Mr. Lott's testimony he discusses the importance of properly "matching" revenues and expenses. In addition, on Page 19, Line 8 of his testimony he states, "Pro forma adjustments give effect for the test period to all known and measurable changes that are not offset by other factors." (emphasis added)

As I explained above, the costs that Mr. Lott is concerned about with his Production Property Adjustment are already "offset" by the Retail Revenue Credit that has been in place since the ERM was adopted in July 2002. Therefore, there is no need for the proforma adjustment advocated by Mr. Lott. In fact, if his adjustment were adopted, it would result in the same costs being adjusted twice, and would lead to a substantial under-recovery of costs by the Company.

With regard to the prior treatment of this issue for PSE, the need for a production cost adjustment related to load growth would be dependent on whether there was a power cost tracking mechanism in place at the time, and whether the design of the mechanism had a production cost adjustment already built in. In addition, in the absence of a tracking mechanism, the need for a production cost adjustment would be even more complex, and would be dependent on the incremental cost of power to serve that load growth.

Thus, the fact that some form of Production Property Adjustment has been used in the past for PSE, does not, in and of itself, mean that the same adjustment is appropriate here. A careful review of the evidence in this case clearly shows that an adjustment is already in place, and that Mr. Lott's Production Property Adjustment should not be adopted.

B. Boulder Park

Q. What is the Company's response to Public Counsel's proposed $4.4 million rate base adjustment related to Boulder Park?

A. Public Counsel's proposed Boulder Park adjustment lacks any independent analysis to support such a recommendation. Mr. Lott's testimony simply references a prior Idaho Public Utilities Commission Order as the basis for his recommendation. In fact, on page 26 of his testimony, when asked to "summarize your understanding of the Boulder Park project," the entirety of Mr. Lott's response is as follows:

> Boulder Park is a project initiated by Avista in 2002 to install additional power capacity by locating multiple generators at the Boulder Park facility. (emphasis added)

The clear indication from Mr. Lott's testimony is that he is not familiar with the Project. (In fact, the Project was initiated in 2001 and placed into service in 2002, and not when Mr. Lott suggests.)

It is important to understand that the Idaho Order referred to by Mr. Lott addressed a number of carryover issues and costs from the energy crisis of 2000 and 2001. In issuing its Order, which included decisions on a broad range of issues, it must be assumed that the Idaho Commission balanced a number of issues in arriving at an outcome that was deemed to be fair, just, reasonable, and sufficient for the Company and its customers. That balancing of interests included a capital structure equity component of 42.6% and an ROE of 10.4% for Avista, which, on a weighted basis, is higher than the 40.0% equity component and 10.4% ROE accepted in this case by Avista through the Settlement Agreement.

All of the same issues from the energy crisis of 2000 and 2001 were previously addressed by the WUTC in multiple orders issued in late 2001 through mid-2002, including the Boulder Park project. The two commissions did not handle all of the same issues in the same way. Differences on certain issues within the orders do not mean that one commission was right and one was wrong, it just means that each commission balanced the public interest in different ways.

More importantly, as I mentioned earlier, the Boulder Park project was previously reviewed as part of the Company's Washington general rate case that concluded in June 2002 through a settlement agreement that was signed by all parties, including Public Counsel. In approving that settlement, the Commission noted that Staff had examined the costs associated with new power supply projects, including Boulder Park, and found that these new projects were "prudently acquired":

> Staff also addresses new power supply costs, the prudence of which was reserved as an issue for the general rate proceeding. *Exhibit No. 14 (Staff Memorandum) at 15-20.* These costs include those associated with the Company's fifty-percent ownership in the Coyote Springs II generation project, its <u>Boulder Park project</u>, and the Kettle Falls CT generation project. "Staff believes [these projects] will provide benefits in the form of firm energy supply and a reduction in exposure to the more volatile wholesale markets." *Exhibit No. 14 (Staff Memorandum) at 15.* Staff states that based on its analysis, "these projects <u>were prudently acquired</u> and that the Company should be allowed to recover associated costs, including capital costs, interest, depreciation, and non-fuel O&M costs on a prospective basis." *Id. at 15-16* (Docket No. UE-011595, Fifth Supplemental Order dated June 18, 2002, Page 11) (emphasis added)

In summary, there is no evidentiary record established in <u>this</u> case for such a disallowance. "Selective" reliance on an IPUC Order is not appropriate, and Mr. Lott's proposed Boulder Park adjustment should be rejected. Furthermore, the prudence of this project has been previously addressed by this Commission.

V. REBUTTAL OF PUBLIC COUNSEL AND ICNU TESTIMONY RELATED TO THE ERM

Q. Public Counsel and ICNU witnesses present testimony related to the Energy Recovery Mechanism (ERM). Do you have any comments on that portion of their testimony?

A. Yes. Mr. Lott raises a number of concerns, from his perspective, regarding the ERM. A reader without a detailed knowledge of the ERM may be led to believe that there are serious problems with the ERM, which is simply not true.

Mr. Lott relies on certain policy goals identified by the Commission in a 1989 rate case, and then discusses six "guidelines" that he suggests the Commission has laid out with regard to PCA mechanisms "in several decisions over the years." (emphasis added)

The most important point to recognize in the whole discussion regarding the ERM is that this Commission has recognized that changes have occurred in the utility industry, which have warranted changes in the way costs are recovered through ratemaking.

The initial policy goals from 1989 relied on by Mr. Lott are over 15 years old, and were discussed at a time when wholesale electric prices were approximately \$22/MWh and natural gas prices were around \$2.10/MMBTU. By comparison current wholesale electric prices are approximately \$80/MWh and natural gas prices are around \$10.00/MMBTU. These higher wholesale prices have created a much higher variation in costs for utilities such as Avista that have a substantial amount of hydroelectric generation, as well as natural gas-fired generation, to serve its customers.

In addition, the utility industry was "rocked" by the recent Western energy crisis. With the current volatility in the wholesale energy markets and lingering concerns from the energy crisis, the financial community is continuing to look to state regulators to provide adequate and timely recovery of costs. The ERM was designed to capture the major changes in costs associated with factors such as hydroelectric generation, wholesale market prices and thermal fuel costs. The financial community has recognized mechanisms such as the ERM as a very important element in the timely recovery of costs.

Q. Is the current ERM mechanism viewed by the financial community as being effective in recovery of costs, as compared to other power supply mechanisms in place across the country?

A. No. While the need for an adjustment mechanism is well-recognized, the size of the "deadband" ($9.0 million) has subjected Avista to greater earnings volatility than other similar mechanisms. Banc of America Securities issued a report in March 2005 titled, "The Kaleidoscope Of Power Regulation In Focus." The report provides the following assessments at page 61 related to return on equity, the common equity ratio, and adjustment clauses in the State of Washington:

- Return on Equity – Average to slightly lower-than-average awarded returns on equity with capital structures that also reflect lower common equity relative to the capital structures adopted by other states, in our view. (underscores added)

- Adjustment Clauses – Fuel and purchased cost adjustments are permitted, and Puget and Avista have adjustment clauses in place. The current plans subject the utility to the risk/reward of under/over collection of a portion of the change in expected costs before costs are passed on to customers. This "dead band" approach has subjected the utilities to greater earnings volatility than a simple recovery mechanism. (underscores added)

The two major points to note from the report are: First, the current ERM mechanism with the $9.0 million deadband is less effective at providing cost recovery for Avista than other similar mechanisms for utilities across the country. Second, Washington State is also recognized as generally providing a lower ROE and a lower equity capital structure.

Public Counsel and ICNU express concerns regarding a shift of risk from the Company to customers with a reduction in the deadband. In reality, with the deadband, Avista is already bearing more risk than other utilities through their mechanisms. Therefore, elimination of the deadband would place Avista in a more comparable position with other utilities regarding the risk that it bears. It also suggests that if the deadband is not reduced or eliminated, the ROE for

Avista should be higher than the other utilities, since Avista is bearing more risk through a less effective cost recovery mechanism.

As explained by Mr. Malquist, Avista will be facing significant capital needs in the future to invest in infrastructure to serve its customers. It is very important that the ERM become more effective in providing recovery of costs, through a reduction of the deadband to no more than $3.0 million as proposed in the Settlement Agreement, and that the ROE approved by the Commission be sufficient to attract capital on reasonable terms.

Q. If the deadband were completely eliminated, would there still be adequate incentive for the utility to manage its costs?

A. Yes. In its original filing, Avista proposed to eliminate the $9.0 million deadband, but retain the existing 90%/10% sharing of costs. Through the Settlement Agreement, Avista has agreed to reduce the deadband from $9.0 million to $3.0 million, and retain the 90%/10% sharing of costs.

Avista's power cost adjustment (PCA) mechanism in the state of Idaho is essentially identical to the ERM, except that it has no deadband. It has the same 90%/10% sharing of costs as the ERM. This 10% sharing of costs ensures that Avista still has a stake in the outcome, and ensures that the Company will manage its costs in the best interest of its customers.

Q. Is there a need to change the mechanics of the ERM?

A. No. Although Mr. Lott discusses a number of suggested refinements to the ERM and makes reference to a "properly designed PCA", the ERM has been in place since July 2002, and apart from the deadband, has been effective in tracking changes in power supply costs that it was designed to address. Avista makes a filing every year to provide the Commission Staff and other interested parties the opportunity to review the costs under the ERM. The costs under the

ERM have been reviewed three times in the past three years, including participation by Public Counsel and ICNU, and the process has worked as intended.

Furthermore, the PCA in Idaho has been in place for over 15 years. It has been refined and improved over those years. The current PCA in Idaho is essentially identical to the existing ERM, with the exception of the deadband. The design of the ERM and the PCA, therefore, has been refined over time and has a proven track record.

Mr. Lott suggests a number of changes to the ERM such as the inclusion of transmission revenues and expenses, brokering fees, etc. He also expresses concern about whether all of the elements are properly included in the calculation of the production cost rate that is used in the retail revenue credit calculation. Many of these items were considered in the original development of the ERM in Washington and the PCA in Idaho, but were ignored because the dollar amounts associated with them were relatively small as compared to the other cost categories that needed to be addressed, and in order to preserve as much simplicity as possible in the design of the mechanism. The absence of these smaller components does not represent a significant shortcoming of the ERM in any sense of the word. However, in the Settlement Agreement Avista has agreed that, prior to January 31, 2006, it will "initiate discussions among all interested stakeholders concerning possible changes to the ERM."

Q. On page 66 of his testimony, Mr. Lott notes that the power cost surcharge has been in place for several years, and on page 79 he suggests that there may be a problem with the deferral account. What is your response to this testimony?

A. It is important to note that a <u>choice</u> was made following the 2000/2001 energy crisis to spread out the recovery of costs related to that crisis over multiple years, rather than implement a higher rate increase. The Company proposed, and the Commission approved, the plan to spread out the costs in order to mitigate the impact on customers.

In addition, recovery of the power cost balance has been hampered by persistent low streamflow conditions. Hydro generation for four out of the last five years has been below normal, which has resulted in increased costs. Therefore, the continuing surcharge is not an indication of a shortcoming in the ERM, but a choice to spread the costs out over time, and has been compounded by low hydro conditions.

In order to make more progress in reducing the power cost balance and provide more timely recovery of costs, the Signing Parties have recommended in the Settlement Agreement that the Commission increase the surcharge by 10% over the current level, which would be equal to $2.7 million on an annual basis.

Q. In his testimony, Mr. Lott suggests there are some cost items in the ERM that should be addressed in a general rate case. Do you agree?

A. No. Mr. Lott expresses concern regarding the inclusion of new power contracts in the ERM. It is reasonable and appropriate that the revenues and expenses from new power contracts be included in the ERM for a number of reasons. In designing the ERM it was recognized that the addition or termination of a power contract would affect other power supply cost items, and in order to capture all cost changes (up and down) on an "apples to apples" basis, it is necessary to include the new contract.

PSE tracks new power contracts, and updates other power supply related costs, <u>outside a general rate case on an expedited basis</u>, through its Power Cost Only Rate Case (PCORC) filings. The PCORC provides interested parties the opportunity to review the changes in costs, including new power contracts, within a shorter time frame than a general rate case.

Under the ERM, Avista identifies any new contract in its monthly ERM report to the Commission, and provides a copy of the new agreement. In addition, as noted earlier, Avista makes a filing with the WUTC on or before April 1st of each year to provide the opportunity for interested parties to review the prudence of power costs during the prior calendar year. The review period runs for 90 days, and can be extended by agreement of the parties or by order of the Commission. Therefore, the costs of any new contracts, under the PCORC and the ERM, are subject to review prior to being approved for ultimate recovery from customers.

In short, many of Mr. Lott's recommendations would serve to make the ERM less effective in providing timely recovery of costs, which runs counter to what the investment community is looking for in today's environment. In addition, ICNU's recommendation to terminate the ERM should be firmly rejected, because of the critical role the mechanism serves in providing recovery of volatile energy costs. The Settlement Agreement, including a reduction in the deadband from $9.0 million to $3.0 million, should be approved. Any further possible refinements to the ERM should be addressed in the discussions that the Company has agreed to initiate on or before January 31, 2006.

VI. ICNU'S RECOMMENDATON TO ELIMINATE THE DIVIDEND IS MISPLACED

Q. Do you have any comments related to Mr. Gorman's testimony regarding the Company's dividend and plans to improve its equity capital structure?

A. Yes. Mr. Gorman requests that the Commission require Avista to suspend all dividend payments until a certain utility-only common equity level is reached. At a time when this Company is continuing to work toward improving its financial strength, it is important that the Company show a commitment to all its stakeholders, which includes its investors. Eliminating the dividend would send a negative message to the financial community, at a time when the Company is trying to attract capital on reasonable terms.

Next, Mr. Gorman requests that Avista be required to disclose its plan for increasing the Company's utility common equity component and wants to ensure that there are adequate penalties if the Company does not reach the necessary higher common equity component. The "Equity Building Mechanism" as set forth in the Settlement Agreement explains Avista's plan to improve its common equity component, which is anticipated to occur through growth in retained earnings and reductions in the outstanding level of long-term debt.

Important components of Avista's plan include the approval of the Settlement Agreement, progress in recovery of the power cost deferral balance of approximately $100 million, and continuation of the ERM with a reduced deadband of $3 million. Without these important components, it would be difficult for the Company to make meaningful progress in reaching a higher equity component.

In addition, the "Equity Building Mechanism" <u>does</u> include automatic reductions in base utility rates if the Company fails to meet the targets set within the mechanism. Therefore, adequate penalties are set forth in the mechanism in order to ensure the Company meets the common equity targets as planned.

VII. DELAY OF IMPLEMENTATION DATE

Q. Please explain the amendment to the Settlement Agreement that delays the implementation of the effective date of the Agreement from December 1, 2005 to January 1, 2006.

A. In response to the Signing Parties' Joint Motion to the Commission related to the proposed procedural schedule for the Settlement Agreement, Public Counsel and ICNU expressed concerns related to the opportunity for adequate review and consideration of the Settlement Agreement. Public Counsel and ICNU suggest that the proposed December 1st effective date will not provide adequate time for briefs, especially in light of the November holidays.

In response to these concerns, and in order to provide additional time for the Commission to complete its deliberations, the Signing Parties have amended the Settlement Agreement to provide for January 1, 2006 as a date-certain for implementation of new rates, if the Settlement is approved. The additional time will facilitate the implementation of revised rates and will also avoid prorations of the deadband under the ERM, which is based on a calendar year.

VIII. CONCLUSION

Q. What is the Commission being asked to do?

A. The Commission is being asked to approve the Settlement Agreement submitted by the Signing Parties, consisting of the Company, the Commission Staff, the Northwest Industrial Gas Users, and the Energy Project. WAC 480-07-750 provides for the Commission to accept—with or without conditions—or reject settlements. Section (1) of this rule states the Commission "will approve settlements when doing so is lawful, the settlement terms are supported by an appropriate record, and when the result is consistent with the public interest in light of all the information available to the commission." It is <u>not</u> being asked to approve an alternative revenue requirement at this time, should the Settlement be rejected.

Q. Please describe how the Settlement Agreement is lawful and "supported by an appropriate record."

A. The direct testimony of the Company provides evidence in support of a much-needed revenue requirement. The Company had filed for $35.8 million in increased electric revenue and for a $2.9 million increase in natural gas revenues, and its evidence would still support a revenue requirement of $33.4 million for electric and $2.6 million for natural gas, were this matter to be fully litigated. The Joint Testimony of the Signing Parties supports the Settlement Agreement and explains its rationale. Further, the Company's rebuttal testimony in response to Public Counsel and ICNU further demonstrates that the Settlement Agreement is reasonable and should be approved.

Q. Why is the Settlement in the public interest?

A. The Settlement is supported by the record and is consistent with the public interest in light of all the information available to the Commission as required by WAC 480-07-750. It strikes a reasonable balance between competing interests, and is the result of extensive discovery and audit work.

The Commission must assure not only fair prices and services to customers, but also that regulated utilities remain financially sound. While more than one "result" may be deemed reasonable, so long as the Settlement falls within the range of reasonableness, it should be viewed as a package, representing a compromise on a variety of issues. This Settlement falls within the "range of reasonableness" that appropriately balances the interests of all stakeholders.

Were the Settlement to be rejected, the Company's litigation position would advocate for electric and natural gas revenue requirements of $33.4 million and $2.6 million, respectively.

Accordingly, the $22.1 million electric revenue increase and the $968,000 natural gas revenue increase is the result of compromises on a variety of key issues.

Were this case to continue to be litigated, the evidence would strongly support an outcome equal to or greater than the dollar amounts in the Settlement Agreement. Moreover, apart from resolving revenue requirement issues, this Settlement has other notable benefits: it provides for a substantial increase in funding of low income DSM and LIRAP initiatives; it imposes an agreed-upon "equity building mechanism" that, over time, will improve the Company's capital structure; it better aligns rate spread and rate design with cost of service; and it makes a much needed revision to the ERM to reduce the level of the "deadband." Taken as a whole, therefore, the Settlement produces an end result that is in the "public interest" and will strengthen the Company's financial condition.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO's. UE-050482 / UG-050483

EXHIBIT NO. ______ (KON-2)

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

Revisions to Avista's Original Electric and Natural Gas Filings

<u>Electric Only Adjustments:</u>

1)	**Colstrip AFUDC**	Avista's original filing proformed out to the 2006 rate year level. The Company agreed to a rate base adjustment at the 2004 test year levels.
2)	**Colstrip Common AFUDC**	Avista's original filing proformed out to the 2006 rate year level. The Company agreed to a rate base adjustment at the 2004 test year levels.
3)	**Colstrip Maintenance**	Avista's original filing modeled Colstrip planned maintenance across all hours of the proforma year. Adjustment is based on historical planned maintenance.
4)	**Cancellation of Small Generation**	Avista has agreed to amortize the costs associated with the cancelled small generation project at the Spokane Industrial Park over a 10-year period previously used by the WUTC, rather than the 5-year amortization period per Avista's initial filing.
5)	**Kettle Falls Fuel Cost**	The Company's Kettle Falls Fuel Cost adjustment in its initial filing understated fuel costs.
6)	**CS 2 Gas Transportation**	The adjustment removes a double counting of the transportation costs for the Coyote Springs 2 project.
7)	**Coyote Springs 2 Fuel**	Coyote Springs 2 fuel costs were adjusted to reflect $7.25 per dekatherm. This adjustment also includes 50-year hydro.
8)	**Misc. Power Supply Adjustments**	These adjustments include several miscellaneous power supply adjustments, including adjustments for power purchase expenses, natural gas transportation and storage expenses, and wheeling expenses.
9)	**Wheeling Revenue**	The 2006 rate period amount of transmission revenue is adjusted to reflect known major changes (e.g. BPA upgrades) that reduce future revenue.

<u>Electric and Natural Gas Adjustments:</u>

10)	**Gain on Sale of Property**	Amortization of the accumulated net gain on property sales over a 10-year period is consistent with the Cancellation of Small Generation adjustment.
11)	**Misc. Accounting Adjustments**	These adjustments include items such as advertising, donations and EEI/AGA dues.
12)	**Software Leases**	The Software Leases ended during the 2004 test year.