BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UG-041515

TESTIMONY OF

KELLY O. NORWOOD

REPRESENTING AVISTA CORPORATION

IN SUPPORT OF SETTLEMENT AGREEMENT

I. INTRODUCTION

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

A. My name is Kelly O. Norwood. I am employed as Vice-President of State and Federal Regulation for Avista Corporation at 1411 East Mission Avenue, Spokane, Washington.

Q. Please describe your education and business experience?

A. I am a graduate of Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. I joined the Company in June 1981. Over the past 23 years I have spent approximately eleven years in the Energy Resources Department (power supply and natural gas supply) in a variety of roles with involvement in resource planning, system operations, resource analysis, negotiation of power contracts, and risk management. I have spent approximately twelve years in the Rates Department with involvement in cost of service, rate design and revenue requirements. I was appointed Vice-President of State and Federal Regulation in July 2001.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain the Settlement Agreement presented to the Commission in this docket, and the reasons why approval of the Agreement would provide for the appropriate resolution of the issues in this case.

II. Context for Settlement Agreement

Q. Please provide the context for the Settlement Agreement in this case?

A. A Settlement in the early stages of this proceeding reflects a recognition by the majority of the Parties in this case that the nature and scope of Avista's filing provides an opportunity for resolution of the case in a manner different than a fully litigated ten or eleven-month process. The Parties to the Settlement include the Staff of the Washington Utilities and Transportation Commission ("Staff"), the Northwest Industrial Gas Users ("NWIGU"), and Avista Utilities (referred to as the "Signing Parties"). The remaining Parties in the case, who participated in the Settlement discussions but chose to not sign the Agreement, were the Public Counsel Section of the Attorney General's Office ("Public Counsel") and the Energy Project/Opportunity Council ("Energy Project") (referred to as the "Non-Signing Parties").

Representatives of the Signing Parties have been participants in the natural gas utility industry for many years and are generally familiar with Avista's natural gas business. In addition, Avista's filing in this Docket is relatively straightforward and does not introduce new methodologies, new allocations or new ratemaking proposals that might be controversial. The rate relief requested by the Company in this case reflects an increase in investment in its distribution system, a general increase in operating costs and financing costs since the last general rate case approximately five years ago, as well as a reduction in therm usage per customer since the last case. The Settlement Agreement would increase revenues by 3.9%.

In short, the Signing Parties concluded that the Settlement provides a reasonable and appropriate resolution of the issues in this case, and that it would not be administratively efficient to litigate the case over another seven to nine month period to achieve an outcome that would not likely be significantly different than that presented in the Settlement.[1]

Q. Is there other available information that contributed to the settlement?

A. Yes. Avista files monthly reports with the WUTC that show its actual rates of return for the Washington natural gas business for the most recent twelve-month period. These reports continue to show that Avista is earning well below what would be considered to be a reasonable rate of return as shown in the table below:

[1] Public Counsel's proposed alternative schedule for this Docket calls for Answering Briefs to be filed May 23, 2005. (Order No. 04 in Docket No. UG-041515, Page 3, Paragraph 11)

Actual Rates of Return for the 12-Month Period Ended:

Jan 2003	5.54%	Jan 2004	4.97%
Feb 2003	5.45%	Feb 2004	5.10%
Mar 2003	4.74%	Mar 2004	5.00%
Apr 2003	4.62%	Apr 2004	4.98%
May 2003	4.47%	May 2004	4.98%
Jun 2003	4.57%	Jun 2004	4.48%
Jul 2003	4.60%	Jul 2004	4.89%
Aug 2003	4.72%	Aug 2004	5.07%
Sep 2003	4.52%		
Oct 2003	4.19%		
Nov 2003	4.62%		
Dec 2003	5.13%		

Q. Was an audit conducted of the Company's operating results that form the basis for the Settlement Agreement?

A. Yes. Prior to entering into the Settlement Agreement, Commission Staff conducted an on-site audit of the Company's 2003 calendar year test period results of operations to verify the need for rate relief. During the audit the Staff identified additional normalizing adjustments that were accepted by the Company for settlement purposes.

Q. How did the Signing Parties address issues that would normally be contentious in a general rate case such as return on equity and various proforma adjustments?

A. For purposes of settlement, Avista agreed to accept a rate of return of 8.68%, which is well below the proposed rate of return in the Company's filing of 9.86%.

In addition, the Company agreed to exclude all proforma adjustments in the determination of the revenue increase in the Settlement Agreement. Proforma adjustments are normally made to reflect known and measurable changes in costs subsequent to the historical test period. These adjustments for items such as wages and insurance costs generally increase the revenue requirement. Therefore, excluding all proforma adjustments in the Settlement Agreement resulted in a lower revenue requirement.

Q. Please explain the importance of the November 1, 2004 implementation date.

A. Avista's agreement to what it considers to be a low rate of return and its agreement to remove all proforma adjustments in the determination of the revenue increase were tradeoffs in exchange for a November 1, 2004 implementation date for the Settlement rates. Therefore, the November 1st implementation date was an important element in the negotiation of the Agreement, and goes hand-in-hand with the revenue increase embedded in the Agreement. In addition, the November 1st date coincides with the proposed date to implement the purchased gas adjustment ("PGA") increase that is now pending before the Commission in Docket UG-041786.

Q. What if the Commission were to determine that more time should be provided for the Non-Signing Parties to further evaluate Avista's pre-filed case?

A. If the Commission were to determine that more time should be provided for Public Counsel and the Energy Project to further evaluate Avista's pre-filed case, Avista and Commission Staff,[2] through a joint motion filed on October 15, 2004, request that the Commission implement rates effective November 1, 2004 on a "subject to refund" basis. The excerpt from the motion is as follows:

> If, however, the Commission should decide to not act on the Settlement until such time as it has allowed for additional process, then joint movants request, by this motion, that the rates nevertheless be put into effect on November 1, 2004, subject to refund, until such time as the Commission does ultimately act on the Settlement. Accordingly, the request to put the rates into effect subject to refund will accommodate not only the provisions of the Settlement Agreement, but will also protect the interests of affected customers in the event the Commission should later reject the terms of the Settlement. (Page 3, Paragraph 6)

Under this provision, if the Commission's later decision were to result in a revenue increase that is less than the $5.377 million implemented on November 1, 2004, the difference between the amount ultimately approved by the Commission and the $5.377 million would be refunded to customers.

Approval of the rates effective November 1 would provide for the timely and efficient resolution of the case for Staff and NWIGU, and would substantially reduce the resources that these Parties would need to dedicate to the case, while Public Counsel and the Energy Project continue their evaluation. Avista would continue to respond to discovery requests from the Non-Signing Parties as quickly as possible, to allow Public

[2] NWIGU has advised Avista and Commission Staff that it does not oppose the motion.

Counsel and the Energy Project to complete their evaluation within a time frame the Commission determines to be appropriate.

III. Summary of Avista's General Rate Case Filing

Q. Would you please provide a summary of the Company's general rate case filing?

A. Yes. On August 20, 2004, Avista filed a general rate increase request for its Washington jurisdiction of $8.6 million, or 6.2%. The historical test period used by the Company is the twelve-month period ending December 31, 2003. After taking into account all standard normalizing or Commission Basis adjustments, plus proforma adjustments to reflect known and measurable changes in revenues and expenses subsequent to the test period, the proforma rate of return ("ROR") is 5.79%.

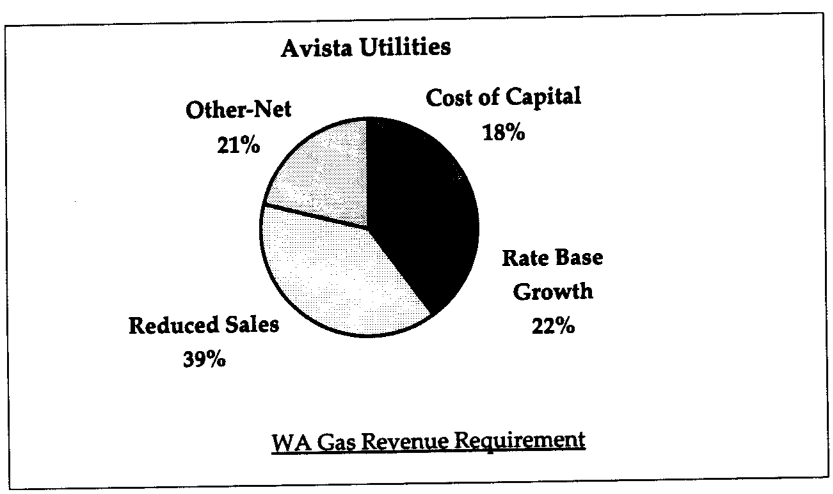
Q. What is the Company's rate of return that was last authorized by this Commission for its gas operations in Washington?

A. The Company's currently authorized ROR for its Washington gas operations is 9.03%. This rate was authorized in Docket No. UG-991607, which became effective on December 1, 2000. For comparison purposes, as noted earlier, Avista has agreed to an 8.68% ROR in the Settlement Agreement.

Q. What are the primary factors driving the Company's need for rate relief?

A. The primary factors contributing to the need for rate relief include new investment in the natural gas distribution system and a general increase in operating expenses in the roughly five years since the last general rate case, an increase in the cost of capital, and a decline in therm usage on a per-customer basis.

The Company's last general rate case was based on a 1998 test period. Since that time Avista has invested an additional $43 million in capital additions and system upgrades to its natural gas distribution system. The requested increase also reflects a general increase in operating expenses over the past five years, and an increase in the Company's financing costs following the energy crisis of 2000 and 2001. In addition, residential average usage has decreased approximately 10% in the past five years. This reduction in usage results in insufficient revenues (margin) to cover operating costs. The following pie chart provides a breakdown of the primary cost drivers:



Q. Did the Company file for any new or unusual regulatory treatment in its direct filing?

A. No. The filing itself was based upon a historical test year for the twelve-months ended December 2003. The Company's operating results for this period of time were included in the "Commission Basis" filing with the Commission on April 30, 2004. Outside of the standard normalizing or Commission Basis adjustments, the Company included proforma adjustments to reflect known and measurable changes in costs subsequent to the test period for items such as labor and insurance costs. Using a proforma embedded capital structure and a proposed return on equity of 11.5% the Company requested an overall rate of return of 9.86%.

Q. Please summarize the terms of the Settlement Agreement presented to the Commission?

A. The Signing Parties have reached agreement on all issues in this proceeding and request that the Commission accept the following settlement provisions:

<u>Revenue Requirement</u> Under the proposed Settlement Agreement, the Company's proposed revenue requirement of $8.6 million, or 6.2%, would be reduced to $5.4 million, or 3.9%. The reduction in revenue requirement reflects the removal of all proposed proforma adjustments and a lower rate of return than that proposed by the

Company. By excluding the proforma adjustments, the revenue requirement in the Settlement Agreement reflects only the standard normalizing or Commission Basis adjustments[3] that have been previously accepted by the Commission.

Rate of Return The Agreement provides for a ROR of 8.68% as compared to the Company's proposed ROR of 9.86%. The Signing Parties have agreed that this is an overall ROR and does not reflect the resolution of any one individual component of the cost of capital.

Rate Design/Rate Spread The $5.377 million revenue increase would be spread to all customers on a "uniform percentage increase of margin," as outlined in Attachment B to the Settlement Agreement. This rate spread proposal is not new and has been previously accepted by the Commission in other cases.

Allocation of Storage and GRI Costs The Signing Parties agree that underground storage costs, related transportation costs, Plymouth liquefied natural gas and certain research contributions be allocated in a manner consistent with the Company's pending PGA filing in Docket UG-041786. Additionally, this methodology would be applied in future general case or PGA filings, unless a different methodology

[3] As stated in WAC480-90-208 (2), the "intent of the 'commission basis' report is to depict the gas operations of a utility under normal temperature and gas supply conditions during the reporting period." Accordingly, the commission basis report includes booked results of gas operations and rate base, and all the necessary adjustments as accepted by the commission in the utility's most recent general rate case or subsequent orders, adjusted for out-of-period, nonoperating, nonrecurring, and extraordinary items, and which reflect operations under normal temperature conditions. Commission basis reports do not include adjustments that otherwise "annualize price, wage, or other cost changes during a reporting period, or new theories or approaches that have not been previously addressed and resolved by the commission."

is ordered by the Commission. This provision does not preclude any party from proposing a different methodology in the Company's next general rate case, should a study support a different methodology.

Effective Date The Signing Parties request that the revenue increase become effective on November 1, 2004 to provide more timely recovery of ongoing operating costs, and in order to coincide with the Company's pending Purchased Gas Adjustment, which was proposed to become effective November 1st.

Q. Why should the Commission approve the Settlement Agreement?

A. The majority of the Parties in this case, after reviewing Avista's filing, have concluded that the nature and scope of the filing is such that it warrants a resolution of the case in a manner different than a fully litigated ten or eleven-month process. The Signing Parties' conclusion is based on a number of considerations including, but not limited to, the following:

1. Avista's filing in this Docket is relatively straightforward and does not introduce new methodologies, new allocations or new ratemaking proposals that might be controversial.

2. It would not be administratively efficient to litigate the case over another seven to nine month period to achieve an outcome that would not likely be significantly different than that presented in the Settlement.

3. Monthly reports filed with the WUTC show that the actual rates of return for Avista's Washington natural gas business continue to be well below what would be considered to be a reasonable rate of return.

4. Prior to entering into the Settlement Agreement, Commission Staff conducted an on-site audit of the Company's 2003 calendar year test period results of operations to verify the need for rate relief.

5. For purposes of settlement, Avista agreed to accept a rate of return of 8.68%, which is well below the proposed rate of return in the Company's filing of 9.86%.

6. For purposes of settlement, the Company agreed to exclude all proforma adjustments in the determination of the revenue increase in the Settlement Agreement. Exclusion of these adjustments resulted in a lower revenue requirement.

7. Avista's agreement to what it considers to be a low rate of return and its agreement to remove all proforma adjustments in the determination of the revenue increase were tradeoffs in exchange for a November 1, 2004 implementation date.

8. The November 1st date coincides with the proposed date to implement the purchased gas adjustment (PGA) increase that is now pending before the Commission.

9. The rate spread proposal is not new and has been previously accepted by the Commission in other cases.

In addition, approval of the rates effective November 1 would provide for the timely and efficient resolution of the case for Staff and NWIGU, and would substantially reduce the resources that these Parties would need to dedicate to the case.

The Company believes there are cases where the circumstances warrant a path to resolve regulatory filings that is different than the traditional approach to processing the filing. In this particular case, the Company, Commission Staff and NWIGU believe this is such a case.

Q. Please summarize the Company's request related to the Settlement Agreement.

A. Avista requests that the Commission approve the Settlement Agreement as filed, with an effective date of November 1, 2004.

In the alternative, if the Commission were to determine that more time should be provided for Public Counsel and the Energy Project to further evaluate Avista's pre-filed case, the Company requests that the Commission implement rates effective November 1, 2004 on a "subject to refund" basis, and establish a time frame for Public Counsel and the Energy Project to complete their evaluation. This alternative would also substantially reduce the resources that Commission Staff and NWIGU would need to dedicate to the case, while Public Counsel and the Energy Project complete their evaluation.

Q. Does that conclude your prefiled testimony?

A. Yes.