BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of Avista Corporation d/b/a Avista Utilities for an Order Approving a Corporate Reorganization To Create a Holding Company, AVA Formation Corp.	DOCKET UE-060273 NARRATIVE IN SUPPORT OF SETTLEMENT STIPULATION

I. PRELIMINARY MATTERS

1 This Narrative Supporting Settlement Stipulation ("Narrative") is filed pursuant to WAC 480-07-740(2) (a), on behalf of the parties signing the Settlement Stipulation ("Stipulation") also filed today in this docket. This Narrative summarizes many aspects of the Stipulation. It is not intended to modify any terms of the Stipulation.

A. Parties to the Stipulation

2 The parties to the Stipulation are the signatories: Commission Staff ("Staff"), Avista Corporation, doing business as Avista Utilities ("Avista"), and the Public Counsel Section of the Attorney General's Office ("Public Counsel") (individually, "Party"; collectively, "the Parties").

3 The other parties to this docket, Intervenors Northwest Industrial Gas Users (NWIGU) and the Industrial Customers of Northwest Utilities (ICNU), are not signatories. However, NWIGU's counsel (Mr. Finklea) and ICNU's counsel, Mr. Perkins, respectively advised Commission counsel (Mr. Trotter) that NWIGU and ICNU neither support nor oppose this Stipulation. Consequently, this is a multiparty settlement, as that term is defined in WAC 480-07-730(3). *Stip.* ¶ *3.*

B. Status of Approvals in Other Jurisdictions

4 On June 30, 2006, the Idaho Public Utilities Commission issued an order approving Avista's reorganization application, based on a settlement in that state.[1] The Federal Energy Regulatory Commission has also issued its "Order Authorizing Disposition of Jurisdictional Facilities" on April 18, 2006.[2] The Oregon and Montana commissions have yet to act on Avista's Reorganization applications.

C. Record for Commission Decision

5 The Parties do not intend to file documentation supporting the Stipulation in addition to the Stipulation, this Narrative, and the proposed testimony and exhibits on file in this docket. *Stip. ¶ 15.* The Parties will be prepared to respond to questions from the Commission at any hearing on the Stipulation, and the Parties are willing to provide additional supporting documents should the Commission deem that necessary or appropriate. To that end, the parties propose to make available a panel of witnesses consisting of representatives of each signatory party, in order to respond to questions from the Commissioners at the time of hearing.

D. Procedural Needs

6 The Company wants the Reorganization to occur by July 31, 2007. That date is primarily due to the pendency of approval dockets in other jurisdictions. The Parties urge the Commission to schedule proceedings to consider the Stipulation as soon as practicable. The Stipulation contains a "most favored nations" provision that sets forth procedures for considering any additional terms ordered by other jurisdictions. *Stip. ¶¶ 26 & 19-24.*

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[1] *In re Application of Avista Corporation, dba Avista Utilities for an Order Approving a Corporate Reorganization to Create a Holding Company, AVA Formation Corp.,* Case AVU-E-06-1 and AVU-G-06-1 (Order 30091).

[2] 115 FERC ¶ 62,080.

II. NATURE OF THE TRANSACTION

7 On February 16, 2006, Avista filed its "Application of Avista Corporation" ("Application") with the Commission, seeking an order authorizing Avista to conduct a corporate reorganization, including the formation of a holding company to be known as AVA Formation Corp (hereinafter referred to as the "Reorganization").[3] This Commission has jurisdiction over such request pursuant to RCW 80.12.

8 Currently, Avista Corporation, doing business as Avista Utilities, is the utility offering electric and/or gas service in eastern Washington, northern Idaho, Oregon and Montana. Avista Capital is a subsidiary of Avista Corporation. Avista Capital currently is the parent corporation of Avista Corporation's non-regulated subsidiary investments and operations.

9 Avista proposes to form a holding company called AVA Formation Corp. ("AVA"). AVA would be the parent corporation of the existing regulated utility, which would be called Avista Corporation (doing business as Avista Utilities). Avista Corporation would become a separate company under the parent company, AVA.

10 AVA would also be the parent company of Avista Capital, Inc., which would continue to hold the non-regulated subsidiary investments and operations, such as Avista Energy, Advantage IQ (formerly Avista Advantage) and Avista Power.

III. OVERVIEW OF THE PROPOSED SETTLEMENT STIPULATION

11 The Stipulation is subject to Commission approval. *Stip.* ¶¶ *1 & 9.* The Stipulation consists of two documents: the document entitled "Settlement Stipulation;" and Appendix A attached thereto. *Stip.* ¶ *4.*

[3] This name will be used in the interim for purposes of designating the holding company. When the new name is publicly announced, Avista will notify the Commission and interested parties.

A. The Commitments are contained in Stipulation Appendix A

12 Appendix A of the Stipulation contains a list of Commitments the Company agrees to meet as a condition of approval. That document speaks for itself. Offered here is a short summary of some of the key provisions.

13 Avista Utilities will keep separate books and records and will not cross-subsidize, or be cross-subsidized, by non-regulated businesses of its parent. *Stip. Appendix A, Commitments 1 & 8.* An agreed set of inter-company cost allocation principles is included. *Id., Commitment 10.*

14 Avista Utilities will maintain its own debt, preferred stock, and corporate credit ratings. *Id., Commitment 13.* The utility's equity will be funded by its parent, who agrees to hold as a high priority the utility's capital requirements. *Id., Commitment 18.*

15 Avista Utilities agrees to increase its equity ratio to 40% by June 30, 2008, and will not pay dividends to the extent doing so would reduce its equity ratio below 30%. *Id., Commitments 21 & 22.* This is a more aggressive schedule than required by the settlement the Commission approved in Dockets UE-050482 and UG-050483.[4]

16 AVA will provide a "non-consolidation opinion" within three months of the closing of the transaction that demonstrates that Avista Utilities will be sufficiently separate so as not to be pulled into a holding company bankruptcy. *Id., Commitment 35.* AVA also agrees it will not support any attempt to cause Avista Utilities to be involved in a bankruptcy, so long as Avista Utilities is financially healthy. *Id., Commitment 38.*

17 Finally, there are several provisions under which AVA and Avista Utilities agree to provide information or other reports to the Commission of ongoing developments, which

[4] The Commission approved an "equity building mechanism" that would result in at least a 38% equity ratio by December 31, 2008. *Settlement Agreement at ¶ 8, approved in Utilities & Transp. Comm'n v. Avista Corporation, Dockets UE-050482 and UG-050483, Order 05 (December 21, 2005).*

will help the Commission to better regulate the utility and protect consumers into the future. *E.g., Commitments 2, 5, 17, 27, 28 & 32 (access to books and information), Commitment 3 (access to personnel), Commitment 23 (notice of dividend increase of 10 percent or more), Commitment 24 (notice of credit rating downgrade), and Commitment 31 (notice of acquisitions).*

B. The docket would be resolved and concluded

18 If the Commission approves the Stipulation, this docket would be concluded, subject only to the possibility of invoking certain described procedures if material terms are added by other jurisdictions. *Stip.* ¶¶ *16 & 19-25.*

C. Effective date and approval procedures

19 Because the Stipulation contains commitments Avista will implement only upon the completion of the reorganization, the Stipulation should only be effective when and if the reorganization occurs. That date is expected to be by July 31, 2007.

20 The approval process is addressed in ¶¶ 12-24 of the Stipulation. If the Commission approves the Stipulation in its entirety, the docket is complete, subject only to procedures under the "most favored nations" provisions. *Stip.* ¶ *16.* If the Commission issues an order approving the Stipulation with a material change, the Stipulation is not effective if a party files a timely withdrawal from the Stipulation. The matter would then be set for hearing, although subsequent settlements are not precluded. *Stip.* ¶¶ *17-18.*

21 The Stipulation is the entire agreement of the Parties, and the Parties recommend the Commission approve it in its entirety. *Stip.* ¶¶ *1 & 12.* The Stipulation sets no precedent. *Stip.* ¶¶ *30-32.*

IV. STATEMENT WHY THE PROPOSED SETTLEMENT IS IN THE PARTIES' INTEREST AND/OR THE PUBLIC INTEREST

22 WAC 480-07-740(2)(a) requires this Narrative to include a "statement of parties' views about why the proposal satisfies both their interests and the public interest." Each Party or, in some cases, a group of Parties, has contributed the following separate statements:

A. Statement by Avista

23 The holding company structure is a well-established form of organization for companies engaging in multiple lines of business, and is increasingly prevalent in the utility industry. Many utilities are organized under a public holding company structure and Avista is one of the few investor-owned utilities in the Pacific Northwest that is not currently organized under a holding company structure.[5]

24 Avista considers it to be in the best interest of the Company, its customers, and its shareholders, to change the corporate structure of Avista into a holding company structure. This Reorganization would provide additional protection for ratepayers by "ring-fencing" or further separating utility operations from the Company's other non-regulated businesses. Such separation would further insulate Avista Utilities and its customers from the risks associated with operating other businesses, while at the same time, permitting greater financing flexibility afforded by a holding company structure.

[5] Other utilities in the Pacific Northwest have received approvals for holding company structure reorganizations in recent years. For example, the WUTC in 2000 approved, with conditions, Puget Sound Energy's proposed corporate reorganization to create a holding company structure. (See Docket UE-991779) In 1998, the Idaho Power Company received approval, with conditions, from the IPUC (Order 27348 in Case IPC-E-97-11), and the OPUC (Order No. 98-056 in Docket No. UM 877) of their application to form a holding company and the execution of a Share Exchange Agreement. (See also, Order 07, "Final Order Approving and Adopting Settlement Stipulation," *In re Joint Application of MEHC and PacifiCorp,* Docket UE-051090 (February 22, 2006)).

25 The proposed Reorganization would not entail the transfer of Utility assets, nor would it adversely affect the financial, technical, and managerial abilities of Avista Utilities. Avista customers would see no change in the Utility or its operations, because the Utility would continue to provide the same high-quality service as before the Reorganization. After the Reorganization, Avista Utilities would continue to be subject to the same regulatory jurisdiction of the Commission as to rates, services, accounting and other general matters of utility operations.

26 The benefits of a holding company structure may be generally summarized as follows: Avista's utility operations will be better separated from the non-utility businesses, making cross subsidization easier to avoid and further ensuring that non-utility business risk will not affect utility operations. Accordingly, the new structure will provide better legal protection for Avista Utilities from liabilities arising from other segments of Avista's businesses. Also, the new structure will permit investors, analysts, and rating agencies to more easily analyze and value the company's individual lines of business. Finally, capital structures and financing techniques may be used that are better suited to the particular requirements, characteristics and risks of the utility and non-utility businesses. Such structures and techniques should increase financial flexibility without adversely affecting the capital structure or creditworthiness of the utility and non-utility businesses. In conclusion, Avista's current corporate structure simply cannot accommodate the same degree of financial and legal separation as can a holding company structure.

B. Statement by Commission Staff

27 Avista Corporation is seeking Commission approval to form a holding company. Currently, the utility, Avista Utilities, is an operating division of Avista Corporation rather

than a separate legal entity. As a result of the proposed holding company structure, the utility will become a separate legal entity. The utility will be called Avista Corporation (doing business as Avista Utilities). The utility's parent corporation will be called AVA Formation Corp. (AVA), though that name is temporary.

28 Staff's goal was to assure the resolution of this docket is fair and just. The result is an agreement Staff supports as solidly in the public interest.[6]

29 Perhaps the most significant impact of this reorganization is that Avista Utilities will be a separate legal entity. It will issue its own securities, with its equity wholly-owned by AVA. Avista Utilities' common equity will be issued by AVA and transferred to Avista Utilities as needed to maintain a reasonable capital structure for the utility. Consequently, Avista Utilities' credit profile will be based on its own, stand-alone credit characteristics, rather than Avista as a whole. This is recognized in Stipulation Appendix A, Commitments 13 and 15.

30 This presents a potential benefit and a corresponding challenge. The primary long term benefit to Avista Utilities is that it will be separated from the impacts of the non-utility operations of Avista Corporation. For ratepayers to realize this benefit, however, the challenge is to get Avista Utilities on as firm a financial footing as possible, as soon as possible.

31 In this regard, the Stipulation calls for Avista Utilities to have a 40% equity ratio by June 30, 2008. *Stip. Appendix A, Commitment 21.* The Stipulation also has an "anti-raiding" provision that prevents Avista Utilities from issuing dividends to AVA if Avista

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[6] The commitments in this settlement are comparable to those made by MidAmerican Energy Holdings Company (MEHC) and PacifiCorp in the agreement approved by the Commission in 2006. *See* Order 07, "Final Order Approving and Adopting Settlement Stipulation," *In re Joint Application of MEHC and PacifiCorp,* Docket UE-051090 (February 22, 2006)).

Utilities' equity ratio is below 30%, or if issuing the dividends would cause Avista Utilities' equity ratio to fall below 30%. *Stip. Appendix A, Commitment 22.*

32 For Staff, Commitments 21 and 22 are the central provisions of the Stipulation because they are concrete ratepayer protections designed to assure that ratepayers benefit from being a "stand alone" company from a corporate credit perspective.

33 Two other critical commitments are: 1) Avista Utilities and AVA's agreement to obtain a non-consolidation opinion that demonstrates that the "ring-fencing" around Avista Utilities "is sufficient to prevent Avista Utilities from being pulled into an AVA bankruptcy" (*Stip. Appendix A, Commitment 35*); and 2) AVA's agreement not to acquiesce, or seek to include Avista Utilities, in any AVA bankruptcy, so long as Avista Utilities is financially healthy. *Stip. Appendix A, Commitment 38.*

34 The non-consolidation opinion is a legal opinion from an outside law firm that the ring fencing is sufficient to prevent Avista Utilities from being drawn into the bankruptcy of another entity or entities in the "corporate tree." AVA also agrees it will not take steps to include Avista Utilities in such a bankruptcy.

35 Other important provisions include Avista's commitment to use "asymmetric pricing" for affiliate charges (*i.e.*, lower of cost or market for purchases *from* affiliates and higher of cost or market for sales *to* affiliates). *Stip. Appendix A, Commitment 10.* This favorable pricing formula is not required by existing statutes.

36 Finally, there are procedural elements such as a "most favored nations" provision, which assures that if any jurisdiction yet to approve this reorganization prescribes or approves additional conditions, this state can take advantage of that, subject to the procedures outlined in the Stipulation at ¶¶ 19-24.

37 In sum, Staff supports the settlement as in the public interest, and urges the Commission to approve the settlement without material change.

C. Statement by Public Counsel

38 Public Counsel believes that the Settlement Stipulation and the ring fencing provisions contained in Appendix A are appropriate and in the public interest. Public Counsel asks the Commission to adopt the Agreement for the reasons outlined below.

39 The Commission has jurisdiction over this proposed reorganization, including the authority to reject Avista Utilities' Application if it is not in the public interest. Public Counsel believes that Avista's Application without the conditions attached as Appendix A to the Settlement Stipulation is not in the public interest because it increases customer risks without offering any real countervailing benefits to counteract these risks.

40 Specifically, without sufficient ring fencing provisions to protect the regulated utility's financial exposure within the new corporate structure, the proposed reorganization potentially threatens the financial health of Avista Utilities. In particular, Public Counsel is concerned about a failure to vigilantly maintain separate books, records and assets to the detriment of Avista Utilities. If AVA were to go bankrupt, the failure to keep separate books, records and assets could financially expose Avista Utilities to AVA's bankruptcy.

41 The reorganization also creates the possibility of cross-subsidy between the regulated and non-regulated businesses of Avista Utilities and AVA. This includes an improper allocation of shared costs.

42 In addition, Avista's Petition potentially jeopardizes Avista Utilities' cost of capital since the regulated utility will be independent of credit ratings assigned to AVA. While this will likely be advantageous to Avista Utilities, the regulated utility enjoys significantly

higher capital needs than other members of the AVA corporate family and therefore, a higher cost of capital would have a greater effect on Avista Utilities.

43 Moreover, Avista continues to maintain a level of common equity well below the forty-percent (40%) allowed for rate-setting purposes in its last general rate case. The failure to ensure increased capitalization upon the reorganization leaves open the possibility that Avista Utilities will fail to meet the common equity level ordered by the Commission and embedded in rates.

44 Public Counsel is also concerned with energy trading transactions between AVA, Avista Utilities and their subsidiaries. The concern arises from the potential for inside information that may or may not be intentionally shared but results in less than optimal market transactions for the regulated utility. Such transactions have been difficult to trace and evaluate. Often the problem arises where there are shared employees between affiliated companies and where employees lack of clear policy guidance regarding restrictions on information sharing.

45 Public Counsel believes the conditions in the Settlement Stipulation will likely mitigate these problems and allow the petition to be in the public interest. For instance, the Agreement requires that Avista Utilities and AVA maintain separate books and be subject to audit by the Commission. AVA and Avista Utilities must also comply with all applicable Commission statutes and regulations regarding affiliated interest transactions. The two companies are prohibited from cross-subsidizing, and must strictly observe a proper allocation of shared costs. Any extension of credit or issuance of bonds between the two companies is prohibited unless approved subject to RCW 80.12. For applicable affiliate transactions, AVA and Avista Utilities agree to use "lower of cost or market" standard for

transactions to Avista Utilities and the "higher of cost or market" standard for transactions from Avista Utilities. Finally, Avista Utilities is restricted from paying dividends in situations where the payment of such dividends threatens Avista Utilities financial well-being.

46 With regard to the cost of capital, Avista agrees to hold ratepayers harmless for any increase in the cost of capital associated with the reorganization. Avista Utilities will maintain separate debt and its own corporate credit rating. Should this fail to occur, provisions are in place to establish potentially greater ring fencing provisions. In addition, Avista Utilities pledges to increase its common equity ratio to forty-percent (40%) by June 30, 2008 or the Company will be required to use its actual capital structure in the next general rate case subsequent to that date. Avista Utilities also agrees that if its common equity ratio falls below thirty-percent (30%) it cannot pay dividends without prior Commission approval. Once the Company reaches its goal of forty-percent (40%) equity, it must report to the Commission if its common equity ratio falls below thirty-five (35%) and explain why the Company's equity has fallen.

47 To address the energy trading concern, as Avista Utilities transitions into a new holding company structure, neither Avista Utilities nor any of its subsidiaries will enter into any electric or natural gas commodity transactions, either physical or financial, with AVA or its other affiliates or subsidiaries, including Avista Energy and Avista Power before December 31, 2009. This condition will not affect any other existing or future limitations on Avista Utilities' energy transactions or trades imposed by the Commission or otherwise. Additionally, Avista Utilities and AVA agree, as a condition of the transaction, to adhere to FERC's Standards of Conduct governing the relationship between Avista Utilities'

transmission function with any of its energy and marketing affiliates, the wholesale merchant function of Avista Utilities and any affiliated power marketer. Avista Utilities and AVA also agree, as a condition of the transaction, to adhere to FERC's rules governing "shared employees" with respect to the merchant and transmission function, including maintaining a list that identifies such shared employee. The purpose of these provisions in the Settlement Stipulation is to ensure that the Commission will have jurisdiction to enforce these FERC requirements as a ring fencing protection warranted by the reorganization.

48 In conclusion, the Agreement satisfies Public Counsel's interests because it sets forth sufficient conditions that are likely to mitigate the potential negative consequences of the reorganization. First, Avista Utilities will be subject to ring fencing provisions that protect its customers' financial exposure, including protection from lower corporate credit ratings due to the reorganization. Second, AVA and Avista Utilities have agreed to limit cash transfers to AVA from Avista Utilities in those instances required to protect the financial health of the regulated utility. Third, AVA and Avista Utilities have agreed to affiliate transaction standards that exceed those required by Commission rules. Fourth, the Settlement provides that Avista Utilities will not seek recovery from ratepayers for the cost of the reorganization. Finally, the Settlement adopts by reference those protections established by the Federal Energy Regulatory Commission for the purpose of regulating electric or natural gas commodity transactions between affiliates or subsidiaries of Avista Utilities.

V. SUMMARY OF LEGAL POINTS THAT BEAR ON THE PROPOSED SETTLEMENT

49 The Parties do not believe there is anything significant to discuss under this topic listed in WAC 480-07-740(2)(a).

VI. CONCLUSIONS

50 The Parties respectfully request the Commission approve the Settlement Stipulation filed in this docket. The Parties understand the Commission has certain discretion regarding the timing and procedures it will use to evaluate and reach a decision whether to approve the Stipulation.

DATED this 5th day of January, 2007.

COMMISSION STAFF

By Donald T Trotter
Donald T. Trotter
Senior Counsel, Office of the Attorney General
Counsel for Washington Utilities and Transportation Commission Staff
Date: 1/05/07

AVISTA CORPORATION

By ______________________________
David J. Meyer
Attorney
Vice President and Chief Counsel of Regulatory and Governmental Affairs for Avista Corp.
Date:

PUBLIC COUNSEL SECTION

By Judith Krebs by Donald T Trotter by telephone authorization 1/05/07
Judith Krebs
Assistant Attorney General, Office of the Attorney General
Public Counsel Section
Date: 1/05/07

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DATED this ___ day of January, 2007.

COMMISSION STAFF

By____
Donald T. Trotter
Senior Counsel, Office of the Attorney General
Counsel for Washington Utilities and Transportation Commission Staff
Date:

AVISTA CORPORATION

By____
David J. Meyer
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PUBLIC COUNSEL SECTION

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