Exhibit No. ___(KSF-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-07______

DOCKET NO. UG-07______

DIRECT TESTIMONY OF

KAREN S. FELTES

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

A. My name is Karen S. Feltes. I am employed as the Senior Vice President of Human Resources and Corporate Secretary for Avista Utilities, at 1411 East Mission Avenue, Spokane, Washington.

Q. Would you briefly describe your educational background and professional experience?

A. Yes. I graduated from the University of Washington with a Bachelor of Arts Degree in Communications with concentrations in Public Relations and Journalism. I went on to receive my M.B.A. from Seattle City University. Prior to joining the Company in 1998, I had a career in human resources for over 20 years. Over the past 10 years I held various senior level HR management positions in both public and private industry, including King County and Microsoft. I have had formal training by the American Compensation Association in the areas of executive compensation and international compensation programs. I am currently a member of the World at Work, formerly the American Compensation Association, as well as a member of the Society for Human Resource Management. In 2001, I was appointed Vice President of Human Resources and in 2006 I became Senior Vice President of Human Resources.

Q. What is the scope of your testimony?

A. I will provide an overview of Avista Corporation's Compensation Program, and I will discuss the role of the Compensation Committee as it relates to setting executive compensation.

Q. Are you sponsoring exhibits in this proceeding?

A. No, I am not.

Q. Would you please provide an overview of Avista Corporation's philosophy on executive compensation?

A. Yes. At Avista, our overarching compensation philosophy is founded in the belief that our success will be driven by our ability to hire, develop and retain the most competent employees. In an effort to recruit and retain such people, we provide salaries, performance incentives and benefits that are competitive in the marketplace, as benchmarked against other similarly-sized energy companies, in regional and national markets. We utilize this same philosophical approach for employees at all levels in the organization. For our professional levels, we annually collect market competitive data from published salary and budget planning surveys for the Northwest/Western regions, regional utilities and other industries. Based on the market salary information, we continue to assure that our organizational pay structures remain competitive in the market by setting merit budgets and salary range changes to reflect market levels.

The main objective in establishing compensation opportunities for executive officers is to provide a link between executive compensation and the goals of:

- Ensuring quality service to our customers in a cost-effective manner,
- Maximizing the value of shareholders' interests, and
- Serving Avista's long-term best interests.

To achieve these objectives for executives, it is vital to:

- Tie a significant portion of incentive, or at-risk pay, to key financial performance goals that support and reinforce Avista's annual and long-term strategic goals.

- Encourage decision-making that meets customers' needs and expectations, as well as decision-making that enhances shareholder value by tying incentive opportunities to attaining customer, corporate and individual goals.

Q. Who is responsible for setting executive compensation, and how is this done?

A. The Compensation Committee of the Board has responsibility for establishing, implementing, and continually monitoring adherence to the Company's compensation philosophy. The Compensation Committee reviews and considers all aspects of the Company's executive compensation programs to ensure they are appropriate, fair, and reasonable, taking into consideration the context of the Company's financial operations and relevant pay practices of comparable companies.

The Compensation Committee believes that an effective total compensation plan should be structured to focus executives on the achievement of specific business goals set by the Company and to reward executives for achieving such goals. Therefore, the Compensation Committee has adopted the following key compensation principles to guide the design and ongoing administration of the Company's overall compensation program:

Clearly communicate the desired outcomes and use incentive-pay programs as an integral part of total compensation to reward the achievement of performance goals to:

- Achieve cost control targets;
- Achieve customer service reliability targets;
- Achieve customer satisfaction targets;
- Achieve earnings-per-share targets;
- Achieve relative stock performance levels compared to peers;

- Create shareholder value;
- Promote a "one company" perspective among all Company employees;
- Maintain total compensation at market competitive levels; and
- Provide a range of payout opportunities based on achieving performance goals.

Q. How is the level and type of executive compensation established, and what criteria determine the compensation received by executives?

A. The Compensation Committee compensates senior management through a mix of:

- Base salary;
- Short-term performance-based cash incentive compensation;
- Long-term equity incentive compensation – performance shares or restricted stock;
- Retirement and other benefits.

The same approach is used in establishing the total compensation for other employees, as well, within the organization. All employees are offered base salary, the short-term incentive opportunity, and "retirement and other benefits.[1]" The long-term equity incentive plan, however, is only offered to officers, employees that hold "director" positions, and assistant officers. This long-term equity component is used, in part, to ensure that the total compensation package is competitive with compensation offered by other comparable companies in the marketplace. It is also noteworthy that 100 percent of this portion of the compensation (long-term equity incentive plan) is paid by shareholders, and none by customers.

Q. What factors are considered with respect to each component of compensation?

A. Factors evaluated in setting Annual Base Salary for officers include levels of pay among executives in the utility and the diversified energy industry, level of responsibility and job complexity, prior experience, breadth of knowledge, and job performance.

Annual Cash Incentives are based on a program shared by all employees of the Company. This program is based on setting performance targets that are strictly customer-focused, and it contains two components:

- Achieving an operating and maintenance cost-per-customer target,
- Meeting three minimum standard performance triggers, including:

  Level of customer satisfaction;

  Duration of the average outage time for our customers;

  Number of sustained outages in a year that our average customer experiences.

In addition to the customer-driven components for all employees, a portion of the executive officer annual cash incentive opportunity is based on meeting capital spending and earnings-per-share targets. In 2006, all targets, except for outage frequency, were met. As a result, the incentive payouts for all employees were proportionately reduced to reflect that portion of the incentive targets not achieved.

The Long-Term Stock Incentive Plan was established by the Board in 2003 to replace stock options. The objectives of this element of compensation are to promote a closer identity of interests between executive officers and Avista's shareholders, focus on long-term performance results, reward relative stock performance levels compared to other mid-cap utilities, and attract

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[1] There is also a supplemental retirement plan for officers and some differences in other benefits, all of which are designed to establish a total compensation package that is competitive with that offered by other comparable companies.

and retain quality leadership, while increasing shareholder return. In addition to the executive officers, other key contributors in the Company are also part of the long-term incentive plan.

In 2006, the plan was adjusted to include a mix of time-vested restricted stock (25%) combined with three-year performance shares (75%). The vesting of these shares over a three-year cycle is intended to enhance the retention element of the executive compensation program. Performance shares are awarded only if Avista's three-year total shareholder return performs at least at the 45th percentile when compared to other peer utilities in the S&P 400 MidCap Utilities Index. The same shareholder return must reach the 55th percentile to fund the stock grants at 100 percent. Stock grants can also be funded above 100 percent when the performance target is exceeded. This was the case in 2006, when Avista's total shareholder return was at the 68th percentile; performance shares received were 122 percent of the shares granted. As noted earlier, these performance shares are funded completely by shareholders, and none by customers.

The Compensation Committee annually reviews the performance of executives. As part of that review, the Compensation Committee reviews the results of annual performance as compared to target to determine approval of annual incentives as well as long-term incentives. Upon completion of the fiscal year, the Compensation Committee assesses the performance of the Company for each objective of the plan, comparing the actual fiscal year results to pre-determined "threshold," "target," and "exceeds" levels for each objective, and an overall percentage amount for meeting the objectives is calculated and audited.

Q. Are perquisites ("perks") provided to executives?

A. No. Because the Compensation Committee believes that the total compensation program provided to executive officers is fair and market competitive, they have not deemed it necessary to provide any additional benefits in the form of perquisites. Therefore, there are no perquisites provided to the CEO, COO, or any other Avista officer.

Q. What steps does Avista take to ensure that executive compensation is competitive in the marketplace?

A. The Compensation Committee annually compares each element of total direct compensation, which includes base salary, annual cash incentives, and the annualized value of long-term incentive grants, against the specific peer group of publicly-traded companies within the energy/utility industry. The companies in the survey universe generally recruit individuals to fill senior management positions who are similar in skills and background to those we recruit, and are the companies with which Avista competes not only for talent, but also for shareholder investment. In 2006, the Compensation Committee engaged Towers Perrin, a nationally recognized consulting firm, to perform a study of the compensation of 30 comparable diversified energy companies in Towers Perrin's Energy Services Executive compensation database with revenues between $1 billion and $3 billion to assure the data presented to the Compensation Committee reflected Avista's general size and scope within the market.

Peer Group Companies

The companies comprising the Compensation Peer Group are:

AGL Resources, Inc.
Aquila, Inc.
Black Hills Energy
Great Plains Energy, Inc.
LG&E Energy Corp.
MDU Resources Group, Inc.
New York Power Authority
NSTAR
Peoples Energy
PNM Resources, Inc.
Puget Energy
TECO Energy, Inc.
UIL Holdings Corporation
United States Enrichment Corporation
Washington Gas
Allegheny Energy, Inc.
Atmos Energy Corporation
Equitable Resources, Inc.
Hawaiian Electric Industries, Inc.
MidAmerican Energy Company
Nicor, Inc.
NorthWestern Energy
Oglethorpe Power Corporation
Pinnacle West Capital Corporation
Portland General Electric Company
Salt River Project (SRP)
Texas Genco Holdings, Inc.
UniSource Energy Corporation
Vectren Corporation
Westar Energy

The Compensation Committee also reviews proxy data on the top five (5) highest paid officers for the companies making up the S&P's 400 Utilities Index. This is the same group that we use to measure relative performance in our Long-Term Incentive Plan. The review includes an evaluation of base salary, annual incentive opportunities, and long-term incentives.

The comparable data review also included four regional peers: Puget Energy, MDU Resources Group, Inc., Sierra Pacific Resources, and IDACORP, Inc. The Committee does not consider compensation data from PUD or non-investor owned utilities, due to the difference in scope and breadth of responsibilities in publicly-traded companies. The Committee uses data from publicly-traded companies within the energy/utility industry as they consider these peer group companies.

The Compensation Committee is also provided with benchmark information regarding the competitive level of health benefits and retirement benefit levels on a periodic basis.

External consultants are utilized to benchmark the benefit programs offered to regular employees in similarly situated peer companies within the energy/utility industry.

Q. What portion of executive compensation is included in the rates of customers of Avista Utilities?

A. In recent years, the total compensation for Avista's executives (particularly the top five Named-Executive-Officers) has been predominantly funded by Avista's shareholders.

As an example, as explained earlier, none of the long-term equity incentive is paid by customers. In addition, the portion of the annual cash incentive that is related to meeting shareholder targets, such as earnings per share, is also not paid by customers. And finally, a portion of officer salaries is also allocated to subsidiary operations, which further reduces the total compensation paid by customers.

For 2006, approximately 62 percent of the top five Named-Executive-Officers' base salary was included in retail rates[2]. Since the foundation of the Annual Cash Incentive Plan is centered on customer service metrics, a portion of the costs of that program, 16 percent for 2006, is also included in rates. Long-term stock incentive awards are paid solely by shareholders and not by customers of Avista Utilities. In aggregate, then, for 2006, 24 percent of the top five officers' total compensation is included in our customers' rates, with the remaining 76 percent being paid entirely by Company shareholders.

The table in Illustration 1 below shows: 1) compensation components for the top five officers for 2006, 2) dollar amounts and percentages currently included in rates, and 3) dollar amounts and percentages of compensation proposed to be included in rates in this case.

Illustration 1

Executive Compensation	2006 Amount paid to Top 5 Executives	Amount Currently Authorized in Rates from Dockets UE-050482 & UG-050483	Average % Currently Authorized in Rates	Amount Proposed in Rates per this Filing	Average % Proposed in Rates per this Filing
Base salaries	$1,904,220	$1,184,213	62%	$1,233,542	65%
Annual Cash Incentive	$1,519,985	$ 244,237	16 %	$ 370,392	24 %
Long-term Stock Incentive	$2,432,567	0	0	0	0
Total 2006 Salary and Incentives	$5,856,772	$1,428,448	24 %	$1,603,933	27 %

Q. How does the <u>average base pay</u> included in rates for the top five officers compare with that of other employees in the Company?

A. The table in Illustration 2 below provides a comparison of the base pay currently in rates for the top five officers, with several of the general employee classifications in the Company. The Director classification includes all top management employees who are not elected officers of the Company. The Professional group includes all exempt employees who are not directors or executives. The Craft classification includes all union employees who are full-time, part-time and temporary.

Illustration 2

2006 Year-End Base Salary Currently Authorized in Rates		2006 Year-End Average Salary per Job Classification		
Executive		Director - $132,048	Professional - $77,766	Craft - $71,323
Position/s	2006 Year-End Base Salary	Comparative Ratio to Position/s	Comparative Ratio to Position/s	Comparative Ratio to Position/s
Top 5 * averaged	$236,843	55.8%	32.8%	30.1%

* *Top 5 officers changed during this time period*

[2] Actual System amount in retail rates determined from amount included in rates for each most recent state general rate case: WA, ID, OR.

The table shows that the base pay for these job classifications ranges from 30.1% to 55.8% of the base pay in rates for the top five officers.

Q. Would you please provide a comparison of the 2006 average year-end <u>total compensation</u> for the job classification of Director, Professional, and Craft to the total compensation of the top five executives, which is currently paid by customers?

A. Yes, the table in Illustration 3 below shows a comparison of the 2006 average year-end total compensation for the various job classifications to the total compensation of the top five executives, which is currently paid by customers. Long-term equity incentives are not represented in this chart because, as discussed in my previous testimony, none of these long-term equity incentives are paid by customers.

Illustration 3

2006 Total Compensation Currently Authorized in Rates		2006 Average Year-End Total Compensation ** per Job Classification		
Executive		Director - $153,395	Professional - $85,310	Craft - $72,142
Position/s	2006 Total Compensation**	Comparative Ratio to Position/s	Comparative Ratio to Position/s	Comparative Ratio to Position/s
Top 5 * averaged	$285,690	53.7%	29.9%	25.3%

* *Top 5 officers changed during this time period*

*** Includes average 2006 year-end base pay plus average 2006 short-term cash incentive target*

The table shows that the total compensation for these job classifications ranges from 25.3% to 53.7% of the total compensation in rates for the top five officers.

Q. Does this conclude your pre-filed direct testimony?

A. Yes.