Exhibit No. ___ (KON-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-07_____

DIRECT 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 as the Vice-President of State and Federal Regulation for Avista Utilities at 1411 East Mission Avenue, Spokane, Washington.

Q. Please briefly describe your educational background and professional 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 of 1981. Over the past 26 years, I have spent approximately 15 years in the Rates Department with involvement in cost of service, rate design, revenue requirements and other aspects of ratemaking. I spent approximately 11 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 was appointed Vice-President of State & Federal Regulation in March 2002.

Q. What is the purpose of your testimony?

A. My testimony will present Avista's request for approval of a process that would allow the Company to file with the Commission to update its base power supply and transmission-related revenues, expenses and rate base between general rate cases. This proposed process, which will be referred to as a Power Cost Only Rate Case (PCORC) is patterned after Puget Sound Energy's (PSEs) PCORC. The proposal includes important safeguards to protect customers, while at the same time would provide more timely recovery of costs for the Company, as well as more accurate price signals for customers.

I will also explain the proposed Production Property Adjustment, included in the filing along with the pro forma period retail loads. The purpose of the Production Property Adjustment is to avoid an over-collection of fixed costs resulting from an increase in retail load from the test period to the pro forma rate year.

II. PCORC - REQUEST FOR AUTHORIZATION

Q. Please explain the Company's request in this filing for authorization of a process to update base power supply and transmission costs between general rate cases?

A. Through this filing Avista requests approval of a process that would allow the Company to file with the Commission to update its base power supply and transmission related revenues, expenses and rate base between general rate cases. This proposed process, which will be referred to as a Power Cost Only Rate Case (PCORC), is patterned after PSE's PCORC. The Company's proposal includes important safeguards to protect customers, while at the same time providing more timely cost recovery for the Company, as well as more accurate price signals for customers.

Q. Has the Commission recently provided guidance related to such a request?

A. Yes. Paragraph 22 of Order No. 4 in Docket No. UE-061411 dated December 26, 2006, states:

> "That said, Avista does have every right (as did PSE) to seek authorization of a PTC [production/transmission cost update] process. The origins of PSE's PCORC demonstrate an appropriate means of doing so. If Avista wishes to pursue its proposal, it must ask authority for the periodic rate adjustment mechanism in a general rate case, presenting evidence and argument clearly defining the proposal, identifying appropriate conditions on its operation, showing how it benefits both ratepayers and stockholders, addressing the costs and benefits of the process based on

performance in a test year and analyzing the effect of an ERM/PTC process on the allowed rate of return."

Q. Why is Avista proposing the PCORC process?

A. During the 1980s, and 1990s power supply related costs, especially those driven by wholesale electric and natural gas market prices, were at relatively low levels compared to today, and were also relatively stable. Wholesale electric prices generally ranged from $20/MWH to $30/MWH, and natural gas prices were in the neighborhood of $2.00/decatherm (DTH). During that period of time, with prices generally low and stable, the addition of new power contracts, major changes in load requirements, and changes in fuel costs generally had a smaller impact than the same kind of changes today.

As an example, during a long-term, low-price, and stable price environment, the expiration of one long-term supply contract, together with execution of a new one would have a minor impact on the costs to serve customers. In addition, if the marginal cost of power to serve new retail load is approximately equal to the price embedded in retail rates for power, the net impact on the Company from the increased power supply costs is relatively small.

These conditions, however, are not in place today for Avista. Pre-existing long-term contracts to serve customers with pricing at $10/MWH to $30/MWH that expire, must be replaced today in a $60/MWH market. In addition, as Avista's retail load grows, the power supply cost to serve the load is approximately $60/MWH, while the revenues embedded in retail rates to cover power supply costs is $39/MWH.[1] These conditions can cause a significant change

[1] $39/MWH references the current Retail Revenue Credit rate used in the Energy Recovery Mechanism (ERM). The Retail Revenue Credit reflects Avista's average cost of production and transmission embedded in retail rates.

in the Company's power supply costs in a short period of time. The Company is also in the middle of a major hydro-electric upgrade program for its Cabinet Gorge and Noxon Rapid facilities. Furthermore, Avista expects to incur significant compliance costs related to relicensing the Spokane River projects, and mitigation of dissolved gas at the Cabinet Gorge hydro facility. These costs to the utility are not short-term variations in costs that can be addressed in a tracking mechanism such as the ERM. They are permanent or long-term changes in production and transmission related costs that need to be included in base retail rates in a timely manner.

Q. Are there other recent changes that drive a need for a periodic update to base power supply costs?

A. Yes. The recent passage of Initiative 937 (I-937) places the Company in the position of needing to acquire significant new renewable resources under the time table specified in the law.[2] Furthermore, the recent increase in demand for new renewable resources has resulted in significant increases in the price of renewable resources available in the market place. These resources will likely be acquired in resource blocks of varying sizes, and sporadically over time as opportunities arise to acquire them. It is important, and appropriate, to have timely recovery of the costs associated with these new resources. The PCORC process would be effective in addressing recovery of these costs.

In addition, the proposed legislation under SB 6001 here in the State of Washington, if put into law, would limit the type of resources that utilities serving customers in Washington may

[2] I-937 requires Avista to acquire new renewable resources equal to at least three percent of its load by January 1, 2012, at least nine percent of its load by January 1, 2016, and at least fifteen percent of its load by January 1, 2020.

choose.[3] Large, conventional base-load coal plants would be precluded, and it may force utilities to acquire resources in smaller resource blocks (as available), which may require more frequent need for timely recovery of costs for these resources.

Under these conditions, even back-to-back general rate cases filed on a continuous basis likely would not provide timely recovery of costs to the Company, would not be administratively efficient for stakeholders to do so, and would not send accurate price signals to customers. There are benefits to all stakeholders in having a PCORC process as proposed by the Company.

Q. Please explain the Company's PCORC proposal and how it would operate.

A. The Company proposes a process under which it would be allowed to file a request with the Commission to update its base power supply and transmission costs between general rate cases. The proposed PCORC process would operate as follows:

1. Although the Company is not required to file a PCORC case, if it chooses to do so it may file only one PCORC between general cases, i.e., following the conclusion of a PCORC, the Company must file a general rate case prior to filing another PCORC.

2. The specific revenue and expense items that would be included in the PCORC are those fixed and variable cost categories that make up the base revenues and expenses included in the Energy Recovery Mechanism (ERM). Company witness Mr. Johnson's Exhibit No. ____(WGJ-5) shows the specific FERC revenue and expense accounts that would be included.[4] The PCORC would also include rate base adjustments to reflect major generation and transmission additions, such as upgrades to existing generation and transmission facilities, the construction or purchase of new resources, and compliance costs (such as relicensing costs) associated with existing resources.

3. The PCORC filing would include testimony and exhibits that include the following:

[3] Proposed SB 6001 provides that, beginning July 1, 2008, the greenhouse gases emissions performance standard for all base load electric generation for which electric utilities enter into long-term financial commitments, is the lower of 1,100 pounds of greenhouse gases per megawatt-hour, or the average available greenhouse gases emissions output of new, commercially available combined cycle natural gas generation turbines.

[4] The dollar amounts in this Exhibit are developed in Mr. Johnson's Exhibit No. ___(WGJ-2).

a. Current or most recent Integrated Resource Plan.
b. Description of the need for additional resources (as applicable).
c. Evaluation of alternatives under various scenarios.
d. Calculations of pro forma power supply and transmission revenues, expenses and rate base that are consistent with the most recent general rate case.
e. Revenue requirement calculations that reflect power supply and transmission revenues, expenses, and rate base items for the pro forma rate period.
f. New base values for future ERM calculations including: power supply and transmission revenues and expenses, retail loads, and Retail Revenue Credit.

4. Following a filing by the Company, hearings would be scheduled to review the rate request. It is contemplated that this review would be completed within four months. Within 30 days following the four-month review, the Commission would issue an order determining the appropriateness of the Company's rate request, and the prudence of any new resource acquisitions. One objective of the PCORC process is to have cost recovery in effect by the time the new resource begins providing service.

5. If the PCORC results in an overall rate increase in excess of 5%, the Company would file a general rate case within three months of the final rate order. Any party to the PCORC case may petition the Commission for an extension, or waiver, of the three-month time frame.

Q. Why are transmission costs included in the PCORC?

A. In a Settlement Agreement in Docket No. UE-060181, which was approved by the Commission on June 16, 2006 in Order 03, the ERM was modified to include transmission revenue and expense categories, and the Retail Revenue Credit was modified to include the fixed and variable costs associated with transmission. Parties supporting that Settlement Agreement included Avista, WUTC Staff, Public Counsel and the Industrial Customers of Northwest Utilities (ICNU). The pertinent sections of the Settlement Agreement are as follows:

> Transmission Revenues and Expenses – The current ERM tracks the variation in net power supply expense, including purchased power and fuel expense, less wholesale sales

revenue. Under the Settlement, transmission revenues (FERC Account 456.100) and expenses (FERC Account 565) will be included in net power costs and expenses under the ERM. Accordingly, monthly variations in transmission revenues and expenses will be included in the monthly ERM calculations. (Section III. (6) (B))

Transmission Fixed-Cost Component – The fixed-cost component of transmission approved for inclusion in rates in the then most recent rate case that is used to deliver power to the Company's system, as well as that used to provide access to the market for the Company's excess power, will be included in the retail revenue credit in the ERM. Until changed, the retail revenue credit, including the transmission fixed costs, is $39.03/MWh. (Section III. (6) (C))

Therefore, the ERM, as recently modified, focuses on both the production and transmission components. In the PCORC filing, these same production and transmission components would be updated.

Q. How would production and transmission costs be treated in the PCORC filing?

A. Production and transmission costs in the PCORC would be treated like they are treated in this rate case. New production and transmission plant additions and the associated revenue requirement would be included in the filing for the pro forma rate year, as well as power supply and transmission revenues and expenses based on pro forma rate year retail loads, power contracts, and resource costs. A Production Property Adjustment, explained later in my testimony, would be applied based on the ratio of test period loads and pro forma rate year loads, in order to avoid an over-collection of fixed and variable costs resulting from the increase in retail load.

Q. What are the benefits to stakeholders from the PCORC process?

A. All stakeholders would benefit from the proposed PCORC process. With regard to customers, the PCORC process would result in smaller incremental rate adjustments over time,

as compared to larger, less frequent adjustments through general rate cases. The PCORC cases would also provide the opportunity to provide more accurate and timely price signals to customers, i.e., the retail prices that customers pay would more accurately reflect the cost of providing service. This continues to increase in importance as we increase our emphasis on demand-side management (DSM) and demand response programs as a means to meet future retail load requirements in the face of higher wholesale market prices. In addition, the PCORC rate adjustments would be easier for customers to understand, because the cases would be more limited in scope, and the factors causing the price change would be easier to identify and explain. The proposed PCORC process includes protections for customers in that the Company would be required to file a general rate case within three months if a PCORC filing results in a rate adjustment of over 5%. This would provide the potential for a subsequent rate reduction if costs were to decline following a PCORC case. As an additional customer protection, the Company would also be limited to no more than one PCORC between general rate cases. Finally, the more timely cost recovery through the PCORC process would result in a stronger financial condition for the utility, which can lead to lower financing costs in the long-term for customers. This more timely cost recovery would also be beneficial to the Company and its shareholders.

With regard to other stakeholders, such as the Commission, its Staff and other parties involved in the rate review process, the PCORC process would reduce the administrative burden associated with establishing retail rates. We believe it is not necessary or administratively efficient to re-litigate the same issues, such as return on equity, various A&G expenses, and even rate spread, in each and every case, especially if these issues have been recently addressed in a

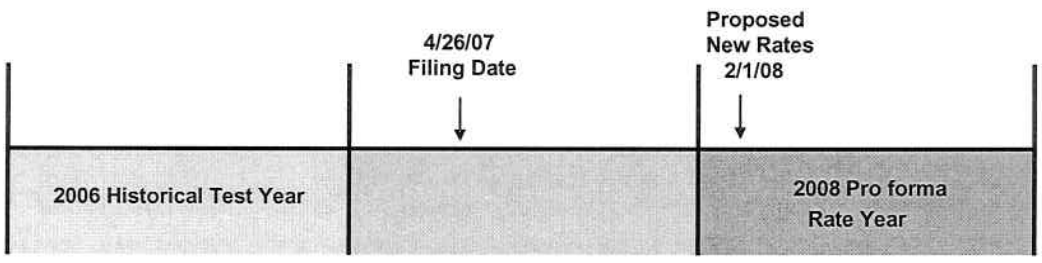
general rate case, or would soon be addressed in a general rate case that would follow a PCORC case.

Company witness Mr. Avera's testimony addresses risk and return considerations related to the proposed PCORC process, and his return on equity recommendation reflects the implementation of the PCORC process. He speaks to the increased importance of timely cost recovery in today's environment, and the investment community's heightened concerns regarding regulatory lag and cost recovery. Implementation of a PCORC process would help address these concerns.

III. PRODUCTION PROPERTY ADJUSTMENT

Q. What is the purpose of a Production Property Adjustment?

A. The theory behind using a Production Property Adjustment is to avoid an over-collection of fixed and variable production costs resulting from an increase in retail load from the historical test period to the pro forma rate period. In this general rate case Avista is using a 2006 historical test period, and a 2008 pro forma rate year. The illustration below shows, for Avista's present case: 1) the 2006 historical test year, 2) the date the current rate case was filed, and 3) the pro forma rate year (calendar year 2008) in which new rates, if approved, will be in place.



In a rate case, the revenue requirement is spread to historical test year loads to establish new retail rates, which for Avista's present rate case is 2006 retail loads. When a rate case is developed to include the fixed and variable power supply costs during the 2008 pro forma rate year, to serve 2008 rate year loads, some method needs to ensure that those fixed and variable costs are not over-collected as the load grows from the 2006 test year to the 2008 pro forma rate year. The Production Property Adjustment serves this purpose.

Q. Does Puget Sound Energy include a Production Property Adjustment in its rate cases?

A. Yes.

Q. Has Avista employed the use of a Production Property Adjustment in prior cases?

A. No. In prior cases Avista has not used a Production Property Adjustment, but in those cases Avista also has used historical test period loads in the determination of pro forma production costs, instead of pro forma rate year loads. In recent rate cases this has led to concerns regarding the proper matching of revenues and expenses in establishing rates.

Q. Please explain.

A. In Avista's most recent general rate case, Public Counsel witness Mr. Merton Lott raised concerns regarding the use of historical test period loads. Among Mr. Lott's concerns was a mismatch of retail revenue, based on historical test-period loads, and pro forma period expenses and rate base. This led to extensive testimony on what Mr. Lott referred to as a "production property adjustment."

On page 15 of his direct testimony (Exhibit No. 281) he stated as follows:

> The "matching principle" dictates that all cost of service components should be considered and evaluated to a similar point in time. (emphasis added) (Lott – Direct Testimony, page 15, line 8, Docket Nos. UE-050482 & UG-050483)

And on page 18 of his testimony Mr. Lott went on to observe that:

> A second type of "mismatch" occurs because the load growth through the 2006 time period, the very growth that facilitated the decision to acquire additional Coyote Spring 2 capacity and energy, has not been proformed or adjusted for in Avista's adjusted results of operations calculation. (emphasis added) (Id., at page 18, line 8)

Q. Why is Avista proposing a Production Property Adjustment in this case?

A. In the Settlement Agreement in Docket No. UE-060181, which was approved by the Commission on June 16, 2006 in Order 03, Avista agreed to address the four issues listed below in its next general rate case, including a Production Property Adjustment.

> 7. Matters deferred to Next General Rates Case (GRC)
>
> With respect to matters deferred to the Company's next general rate case (GRC), the parties agree as follows:
>
> (1) The Company agrees to file testimony in its next GRC on the cost of capital impact of the ERM;
>
> (2) The Company will file a prudence case on its hedging strategy for power purchases and purchases of gas used for power generation, on a prospective basis, in its next GRC;
>
> (3) Consideration of the allocation of common costs related to the retail revenue credit will be addressed in the next GRC; and
>
> (4) Consideration of a production property adjustment will be addressed in the next GRC. (emphasis added) (Settlement Agreement, Page 4, Section 7)[5]

[5] In this filing, Mr. Avera addresses Item 1 involving the cost of capital impact of the ERM, Mr. Storro addresses Item 2 related to the Company's hedging strategy, and Ms. Knox addresses Item 3 related to the allocation of common costs.

In this filing, Avista has made two changes related to this Production Property issue. We have included a Production Property Adjustment, and we have incorporated 2008 pro forma period retail loads in the determination of pro forma power supply revenues and expenses.

We believe these changes fully address the concerns raised by Mr. Lott, and will, in fact, result in a better matching of revenues and expenses during the period that new retail rates from this rate case will be in effect. The use of 2008 pro forma loads will result in pro forma revenues and expenses in this filing that are much closer to what is expected to occur during the 2008 rate year, and the Production Property Adjustment will ensure that the Company does not over-collect its fixed and variable production costs. Retail Revenue Credit adjustments in the ERM would be relatively small, since any true-ups would be based on a comparison of actual load for 2008 versus the 2008 pro forma load included in base rates.

We have also applied the same theory to transmission fixed and variable costs in the development of the Production Property Adjustment. As loads grow, new customers (new retail KWH sales) will contribute toward recovery of these transmission costs, and we have applied the same adjustment to transmission costs. Application of this Adjustment to transmission costs reduces the Company's revenue requirement in this filing. Therefore, the proposed Production Property Adjustment ensures that both production costs and transmission costs are not over-collected during the year that rates go into effect.

Q. How is the Production Property Adjustment applied?

A. The production and transmission costs, both fixed and variable, that are included in the proposed retail rates in this case are factored down by the ratio of the Washington 2006 test period loads and the Washington 2008 pro forma rate year loads. This ratio is then applied to the

Production and Transmission operating and maintenance expenses, including depreciation and amortization expense, as well as net Production and Transmission rate base.

The load ratio for this case is 0.95127, which is determined by dividing the 2006 Washington test year retail load of 5,414,826,000 KWh, by the 2008 Washington pro forma rate year retail load of 5,692,181,000 KWh. Company witness Ms. Andrews has included the Production Property Adjustment in her development of the Company's revenue requirement.

Company witness Mr. Kalich included the 2008 pro forma rate year loads in the AURORA model so that the costs associated with serving the loads are reflected in this case, and he provides further explanation of these loads in his testimony.

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

A. Yes.