BEFORE THE WASHINGTON STATE

UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant,	)	Docket No. UE-050482 UG-050483
vs.	)	Volume IV Pages 368 - 619
AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	)	

A hearing in the above matter was held on October 18, 2005, from 9:00 a.m to 5:05 p.m., at 1300 South Evergreen Park Drive Southwest, Room 206, Olympia, Washington, before Administrative Law Judge KAREN CAILLE and Chairman MARK H. SIDRAN and Commissioner PATRICK J. OSHIE and Commissioner PHILIP B. JONES.

The parties were present as follows:

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P R O C E E D I N G S

JUDGE CAILLE: We are here for day two of the Avista multi-party settlement hearing in Docket Number UE-050482 and UG-050483. And I see Dr. Avera is on the witness stand, if you will please stand and raise your right hand, I will swear you in.

(Witness William E. Avera was sworn.)

JUDGE CAILLE: Thank you.

Mr. Meyer.

MR. MEYER: Thank you.

Whereupon,

WILLIAM E. AVERA,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Good morning, Mr. Avera.
A. Good morning, Mr. Meyer.
Q. For the record, would you please state your name and who you're associated with.
A. William E. Avera, I'm the President of FINCAP, Incorporated, 3907 Red River Street, Austin, Texas.
Q. And have you prefiled both direct testimony

and rebuttal testimony as well as accompanying exhibits in this case?

A. Yes, sir, I have.

Q. Do you have any changes or corrections to make to any of those?

A. I have one change to my rebuttal testimony, which is Exhibit 62 at page 7.

Q. Allow a moment for us to get there.

A. At line 2 at the end of --

Q. Excuse me, Mr. Avera, just one moment.

All right.

A. At line 2 at the end there is a Footnote 5, that footnote should be stricken and at the bottom of the page the reference to that footnote similarly stricken.

Q. Do those complete your corrections?

A. Yes, sir.

Q. So if I were to ask you the questions that appear in both your prefiled direct testimony marked as Exhibit 50 as well as your rebuttal testimony marked as Exhibit 62, would your answers be the same?

A. Yes.

Q. And have you also sponsored Exhibits 51 through 61 as well as 63?

A. Yes, I have.

Q. And is the information contained within those exhibits true and correct?

A. It is to the best of my knowledge.

MR. MEYER: Thank you.

With that, I move the admission of Exhibits 50 through 63.

JUDGE CAILLE: Are there any objections?

Then Exhibits 50 through 63 are admitted into the record.

And, let's see, cross by Mr. ffitch.

MR. FFITCH: Yes, Your Honor.

JUDGE CAILLE: Are you going to start, okay.

MR. FFITCH: Thank you.

Good morning, Commissioners and Judge Caille.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good morning, Dr. Avera, it is Dr. Avera, is it not?

A. Yes, it is, Mr. ffitch, it's good to see you again.

Q. I was going to say that I believe we have encountered each other at least once before in this hearing room.

A. We have.

Q. So welcome back. As you know, I'm the lawyer for the Public Counsel office with the Attorney General here in this state.

A. Yes, sir, I'm aware of that.

Q. Now, Dr. Avera, you performed your cost of capital analysis back in January or February of this year; is that correct?

A. That is correct.

Q. And you did not update the ROE estimate, return on equity, in your rebuttal testimony, did you?

A. I did not.

Q. And I'm going to be using equity cost or return on equity as interchangeable terms here, is that okay with you, they are interchangeable, are they not?

A. Well, not exactly, Mr. ffitch. I think there are technical differences in the way they are used. Cost of equity is a magnitude that arises in the market. Return on equity is a magnitude that is a creature of the Commission and economic events.

Q. All right. Well, let's use equity cost as a term here then rather than ROE.

A. Okay.

Q. Unless I say return on equity specifically.

A. Yes, sir.

Q. Now let's start with taking a look at the discounted cash flow or DCF equity cost estimate, and you provided a discounted cash flow estimate in your direct testimony in this case of 9.8%, correct?

A. Correct.

Q. Now can you turn, please, to do you have a copy of Mr. Hill's testimony up there?

A. I do.

Q. Could you please turn to page 82 of Exhibit 261, that's his direct testimony.

MR. MEYER: That page again, please?

MR. FFITCH: Page 82.

MR. MEYER: Thank you.

MR. FFITCH: Exhibit 261.

BY MR. FFITCH:

Q. Do you have that?

A. I do.

Q. And I'm looking at the top paragraph there, and doesn't Mr. Hill indicate there that if you had redone your discounted cash flow analysis at the time when Mr. Hill prepared his testimony here in August of this year that your discounted cash flow result would have declined to 9.3%, which is very similar to Mr. Hill's 9.25% recommendation?

A. That's what he says.

Q. All right. Now my question for you,

Dr. Avera, is where in your rebuttal do you specifically address Mr. Hill's testimony regarding the update of the discounted cash flow analysis?

A. I don't address it. I didn't look to Mr. Hill's update to see if I agreed with it. The application of the DCF model as explained in my direct testimony requires judgment as you look at the different growth rate indicators to determine which best represents what investors think. So in order to truly update my analysis, I would have to look at all the growth indications and apply my judgment, and I have not done that.

Q. Okay, thank you. So you decided not to update it, and in your view it wasn't an appropriate thing to do, and you have just given us a brief explanation of why that is, but the fact is you did not update the DCF analysis, correct?

A. I did not update it because I felt that the evidence that was in my direct and rebuttal were sufficient to confirm that the 10.4 did not exceed the cost of equity.

Q. Okay. Now can I get you, please, to turn to your response to Public Counsel Exhibit 714, which has been marked as one of your cross exhibits, and that's Exhibit 64.

A. Yes, sir.
Q. And essentially what that data request does is ask whether since you last testified in Washington you have changed your analytical methodologies, correct, that's a paraphrase?
A. Yes.
Q. And you have in your answer indicated that you essentially perform two different analyses, the discounted cash flow approach and the risk premium approach, correct?
A. That is correct, in both the earlier testimonies as well as this one.
Q. All right. And then here you indicate that there are some changes in the risk premium analysis in this case, and then you describe them?
A. Yes.
Q. Now before we get into those, some details on the risk premium analysis, I just wanted to sort of check my memory, isn't your discounted cash flow analysis different than the DCF methodology that you used in the last Avista docket also?
A. Well, I think the methodology is the same. As I discussed earlier, my understanding of the proper allocation -- application of the DCF is we're trying to replicate what investors have in their minds when they

pay the observed market price for the stock.
     Q.   Dr. Avera --
     A.   So in order to do that, we have to look at various indicia of what investors require.
           MR. FFITCH: Your Honor --
     A.   And it's not something that's mechanical.
           JUDGE CAILLE: Mr. ffitch, I think that the Bench needs to hear the rest of Dr. Avera's explanation.
           MR. FFITCH: Thank you, Your Honor, my concern is that the witness is not answering the question but is engaging in an unrelated speech, but I will try not to step on his answers, thank you, Your Honor.
           JUDGE CAILLE: And if you will just make sure your questions are very narrow, and, Dr. Avera, if you will please try to answer the narrow question.
           THE WITNESS: Yes, Your Honor.
BY MR. FFITCH:
     Q.   Well, here's my specific question on the DCF, and I'm really just focusing on the multistage discounted cash flow analysis versus a single stage discounted cash flow analysis, and that was really what my question was, do I recall correctly that in the last Avista docket in this state that you used a multistage discounted cash flow analysis?

A. Well, I'm not sure it was the last one. I think in previous -- there has been a previous case where I have used the multistage because I felt that it was necessary to use that to capture investor expectations. Because at that time, the utility industry was in a time of transition, and investors viewed the future as a discontinuous, that there would be one set of growth for the period of transition, and then there would be a longer term equilibrium growth. So I was still applying the same DCF model, I was just modeling what I believed to be investor expectations as they were then as opposed to as I believe they are now.

Q. So perhaps you're refreshing my memory, that was in the '99 docket rate case, I think it's 991601, that was where you used the multistage DCF and not in the immediate last docket; is that right?

A. That is correct, the immediate -- I think I have filed two previous rate of return testimonies here in Washington.

Q. Okay. And so then just to clarify, you did not use that multistage discounted cash flow analysis in this docket?

A. That is correct, because I don't feel that that captures investor expectations in 2005.

Q. Okay. And I understand that you have said that you have testified a couple of times, that you're using the same analytical approaches, I think we can stipulate that discounted cash flow and risk premium analyses are used in most of these cases. That's not what we're talking about, we're talking about the specific components of those methodologies and variations within those approaches, aren't we?

A. Well, I'm responding in this exhibit to a request about analytical methodologies, and to me there are two different generic approaches, the DCF which looks at the price of stock in the marketplace, and the risk premium which looks at the yield of bonds in the marketplace, so those are the two analytical methodologies that I used then and now.

Q. Understood. And we're not talking about the generic methodologies, we're talking about some different ways of skinning those two cats, aren't we?

A. Well, I think to apply the methodologies, when I was in graduate school my methods professor made the distinction between methodology, which is the philosophical approach you're using, and the methods, which are the particular calculations or estimates you do. So the methodologies are the same, the methods change according to facts and circumstances.

Q. All right. So let's turn to the specific ways in which the methods for your risk premium analysis have changed between this docket and the last one that you testified in this state. And we're still looking at Exhibit 64, and these are differences in your risk premium methods, and you cite two differences in the DR response. The second one is a different approach to the capital asset pricing model, right, or what's known as CAPM?

A. Yes.

Q. Now you didn't use CAPM or the capital asset pricing model at all in the Avista cases in this jurisdiction in the 991606 docket, did you; do you recall?

A. I don't have a specific recollection, Mr. ffitch.

Q. Okay. Can I get you to turn to page 44 of your direct, and that's Exhibit 50.

Do you have that? And there you show your risk premium results, correct, at the top of the page?

A. That is correct.

Q. And the top four numbers are bond yield plus risk premium, and the bottom four are your capital asset pricing model results, correct?

A. That is correct. The bond yield plus risk premium is one way of categorizing the approaches that don't use the capital asset pricing model. All are risk premium approaches.

Q. As the heading shows, thank you.

And the capital asset pricing model produces the highest results, correct, as we see on this chart?

A. Yes.

Q. Now we also see on this table of numbers that all of your risk premium analyses have a current estimate and a rate year estimate, correct?

A. Correct.

Q. Now in Exhibit 64, your response there says that one of the differences in your testimony this time is that you have elected to incorporate projected bond yields into your risk premium methods, so is it safe to assume that your rate year estimates are those that include the bond yield projections?

A. Yes, they do.

Q. Okay. Now you didn't do that in your testimony in the last docket in Washington, the 041515 docket, correct?

A. That is correct.

Q. And do you recall whether you did that in the 991601 docket in Washington?

A. I don't believe I did.

Q. In all of those rate year estimates, which are the ones you did not do in the last two cases, those are higher than each of the current estimates shown here, correct?

A. Yes, because it reflects the reality that we're in a rising interest rate environment, which was not the case in the previous times I testified. And I thought it was important, as I explained in my testimony, that the Commission consider the reality of the rising interest rate environment in establishing rates.

Q. Are current long-term interest rates higher now than they were at the first of the year, Dr. Avera?

A. Many are, especially as of today after the announcement this morning that the producer price index went up 6.9%, which is the largest increase since 1990, and since Dr. Greenspan's address last night which indicated concern about inflation and an intent to continue with the increases in the short-term rates of which there have been 11 so far, and there have been 5 since the beginning of the year.

Q. Are there long-term interest rates that are not higher than they were at the first of the year?

A. Well, I haven't looked at all the, you know, there are a lot of long-term interest rates, but the 20 year that I use in my testimony is higher now than it was when I did my testimony. The 60 day or 90 day treasury bill rate that Mr. Hill used is higher now than when he did his testimony. The 30 year treasury bond is considerably higher now than when he did his testimony. So interest rates have gone up since the first of the year and especially since the testimony before the Commission has been filed.

Q.   Now in preparing your estimate of equity costs in this case, you relied on a financial forecast that showed a 20 year treasury bond yield over various quarters of 5% in the first quarter, 5.2% in the second quarter, and 5.4% in the third quarter, did you not?

A.   Yes.

Q.   And that was the Blue Chip Financial Forecast?

A.   That was one of them, I think I used three different forecasts, but that was one of the forecasts I used.

Q.   Okay. And can I ask you to please refer to Public Counsel Exhibit 73; do you have that?

A.   Yes, I do.

Q.   Now that's a Federal Reserve Statistical Release showing selected interest rates, and that's dated October 11th, 2005, correct?

A.   That's correct, the latest interest rate shown is October 7th, which is two weeks ago.

Q. Okay.

A. More than two weeks ago.

Q. Well, I'm going to take you down to the 20 year treasury, this is about two thirds of the way down the page, the main heading is U.S. government securities, then treasury constant maturities, and then there are nominal numbers for different time periods, and the 20 year number is at the bottom of the list; do you see that?

A. Yes.

Q. And if we go across to the week ending September 30th, we see 4.59 as the interest rate, correct?

A. Yes. The most recent week, I looked at it on the Internet this morning, is 4.77.

Q. Right, well, this number is almost 100 basis points below the Blue Chip projection that we just discussed, correct?

A. Yes, it is, but --

Q. And the update that you mentioned is still significantly below, no longer 100 basis points, but still quite significantly below the projections that you looked at in the Blue Chip forecast?

A. Yes.

Q. Those forecasts didn't turn out to be correct, did they?

A. Well, we're not there yet. Forecasts are not generally exactly on the money. If you looked at my resume', Mr. ffitch, you know I began my professional career in the Navy as a weather person, so I'm very much aware of the difficulties of forecasting. But I think the general view and consensus of rising interest rates that is reflected in my testimony is still very much current in the investments in the marketplace in investors' minds, so we're not there yet, and I think interest rates are indeed rising.

Q. Did you use projected stock prices in your discounted cash flow analysis?

A. No, I did not.

Q. Can I ask you now to turn to Exhibit 62, which is your rebuttal testimony, and I'm going to ask you to turn to page 19, and there's a Q&A that goes from line 3 to line 13. Essentially this question and answer is a discussion by you of Mr. Hill's reference to an AG Edwards publication on the gas utility industry, correct?

A. Correct.

Q. Now you don't dispute, do you, that the AG Edwards publication is informing its investor clients that they can expect to earn average returns on their gas utility investments of 8.4%?

A. That is correct, that is the figure that appears in their report.

Q. Is it your testimony that a national brokerage firm like AG Edwards would provide faulty or misleading information to its clientele?

A. No, I think they do the best they can helping their investors know the future. I think they know, as investors know, that AG Edwards, a very respected regional investment firm from Saint Louis, doesn't know the future any more than Goldman Sachs or Merrill Lynch or any other investment analysis firm.

Q. Can I ask you now to turn to page 14 of your rebuttal testimony, Exhibit 62 still. Are you there?

A. Yes.

Q. And there you discuss Mr. Hill's reference, and I'm looking at the question on line 7 and then the answer, you discuss Mr. Hill's reference to the relationship between market to book ratio, return on equity, and the cost of capital, correct?

A. Yes.

Q. And you cite Roger Morin's book for support that Mr. Hill's position is flawed, correct?

A. Yes.

Q. And that is actually cited in the footnote there, Footnote 19, correct?

A. Correct.

Q. Now can you please turn to Exhibit 74, this is one of your cross exhibits.

A. Yes, sir. I would point out I have -- my copy of those pages of the book, the cross exhibit, has the pages out of order, and it also ignores -- doesn't include the last page of this discussion which is on page 250.

Q. All right. When you say out of order, do you mean 49 coming before 48?

A. Yes.

Q. Okay, I'm not -- you may be -- I'm hoping you're alone in that. We had -- the intention is that the exhibit will have a cover page from the Morin text, page 248, followed by page 249.

JUDGE CAILLE: That's what we have up here, Mr. ffitch.

MR. FFITCH: Thank you.

BY MR. FFITCH:

Q. Now this is a cover page and then the excerpt from this same text that you cite in your testimony, correct?

A. Yes, sir it is.

Q. And the page that we're looking at is entitled the market to book ratio and the cost of capital in theory, right?

A. That's correct.

Q. And just kind of walking through some of the terms here, capital M represents the market price, correct?

A. Correct.

Q. And capital B is the book value; is that right?

A. Correct.

Q. And lower case r is the expected return on equity, correct?

A. Yes.

Q. Now the return on equity is defined as the earnings divided by the book value of the firm, correct?

A. Yes.

Q. And that's an accounting based measure of return, right?

A. That is correct.

Q. And then capital K is the cost of equity capital, right?

A. That's correct.

Q. And the cost of equity capital is a market based measure of return, correct?

A. That is correct, it exists in investor requirements.

Q. All right. And that's what we're trying to estimate when we use the discounted cash flow and the capital asset pricing models and other methods, correct?

A. Yes, sir.

Q. Now if you could look at the bottom of page 248, which is page 2 of the exhibit, and I think the numbering at the top, the internal numbering at the top of the page is incorrect, but it's the second page of the exhibit, page 248 of the Morin text, if you look at the bottom of that, please, we have a formula that states, and I'm paraphrasing the one aspect of it, but essentially it states that the market to book ratio will be greater than 1 if the earned return is greater than the cost of equity capital; is that correct?

A. That's correct.

Q. Now let's turn to the next page of the text, if you would, that's page 249, page 3 of the exhibit. And if you could, please, I won't ask you to read the whole top section, it's referring to what's described as equation 10-7, correct, and could you read the last sentence before the shaded block, please, starting equation 10-7.

A. Yes.

Equation 10-7 provides a method of
finding the cost of equity capital that
is consistent with the observed M/B
ratio.

Q. Okay, and that's referring to market to book ratio, correct?

A. Correct.

Q. And Morin's equation 10-7 is the same equation that Mr. Hill uses in his market to book equity cost analysis, correct?

A. It is correct, but I should point out that Professor Morin in the last paragraph starts talking about why this can't be applied, and then had the exhibit included page 250, there were three more reasons why it is unrealistic and not practical.

Q. And have you addressed whether or not Mr. Hill dealt with those issues in his testimony?

A. I don't believe he did, and there are other issues other that the ones that Professor Morin wrote down in 1994. I recently had a conversation with Dr. Morin about this issue, and one of the big problems of course is the book value we observe for electric utilities is affected by accounting rules. As you mentioned earlier, it's an accounting number. In recent years because of accounting rules, a number of electric utilities have had significant writedowns of their book value, so those writedowns drive book value when there is no change in market value but the apparent market to book changes dramatically.

MR. FFITCH: And, Your Honor, we would be happy to have the company submit the additional page to this exhibit if that's their preference to complete the discussion on this issue out of the text.

MR. MEYER: We can take care of that, or through redirect I will visit with the witness about some of the other critiques on the following page.

BY MR. FFITCH:

Q. I would like to now turn to the topic of capital structure, if I could, Dr. Avera. And again looking at your rebuttal, Exhibit 62, and can I get you to turn to page 55, please. That's at line 24, last line on the page, and there you state:

Mr. Hill derived a "utility-only" capitalization based on a separate, divisional equity balance and assigning all of Avista's outstanding debt to utility operations. Based on this arithmetic, Mr. Hill concluded that Avista's jurisdictional utility operations were actually financed with

29.26% common equity.

That's a correct reading, isn't it?

A. Yes, sir, it is, Mr. ffitch.

Q. Now are you aware, Dr. Avera, that Avista states in its 2004 10-K that 65.8% of the common equity appearing on the balance sheet was invested in Avista Utility and 34.2% of it was invested in Avista Capital, which is an unregulated affiliate?

A. I'm aware of that representation, the exact numbers seem familiar, but I'm aware there was a representation of the proportional equity.

Q. You're not representing or testifying in this case that that is an unimportant factor, are you?

A. Well, I'm saying it's important for certain circumstances, but from an investor's perspective, an investor can not invest in a utility, Avista Utility only. There is no holding company here, there is only Avista Corporation. So the stock and the bonds are obligations and represent an investment in Avista Corporation. So while you can separate the equity and you can make calculations, from an investor perspective, the relevant capital structure is the corporate capital structure.

Q. Well, this issue is important enough for Avista management to put this on page 1 of the 10-K, wasn't it?

A. That is correct, it is a proper disclosure. But for the purposes that Mr. Hill and I are engaged, which is to estimate the cost of equity and to determine the appropriate capital structure that goes with that cost of equity, I think it's important to keep in mind that investors must invest in the total entity.

Q. Well, we also are taking into account the interests and perspective of rate payers in this case, are we not, Dr. Avera?

A. Absolutely, I think customers are foremost in everyone's thoughts in terms of resolving the case before us. I think that goes without saying. From my experience as a regulator, I'm very mindful of that.

Q. And would you disagree that to the extent that rate payers are paying a return on equity on a capital structure above this 30% utility-only capital structure that that constitutes a rate payer subsidy?

A. No, sir, I do not agree. I don't think the customers are paying too much, because I think customers get the benefit of the entire capital structure. That's what stands behind the bond ratings that determine the debt cost, and that's what the customers get the benefit of. So I don't think there is a subsidy, I disagree very much with Mr. Hill's characterization of that as a subsidy.

Q. Are you aware, Dr. Avera, that Avista responded in this case to data requests stating that all of the debt that appears on Avista's balance sheet is utility debt?

A. Yes, I am aware of that.

Q. And so when you stated here in your testimony that Mr. Hill assigned all of Avista's debt to the utility, what did you mean by that?

A. That he assigned it to the utility, but it is still Avista debt. It is the Standard & Poor, I think there is a cross exhibit which is a Standard & Poor's rating of Avista, the Standard & Poor's rating is a rating of Avista Corporation. Avista Corporation issues the debt, it is assigned to the utility operations, but it is still Avista Corporation debt.

Q. And it's assigned by Avista, correct?

A. Yes.

Q. As a factual matter, that's not an opinion of Mr. Hill, is it, that's an assignment by the company that he is simply relating in his testimony, correct?

A. That is an assignment, but it's still from an investor's perspective does not change the reality that an investor invests in Avista Corporation, both the equity and the debt. And since we're talking about equity especially here, the equity is equity of the corporation. The investor can not do the Chinese menu thing and say I only want to buy stock in the utility, they must buy stock in the corporation.

Q. And similarly, the rate payer has no choice either as to what rate they pay to subsidize a return on equity on equity that is not utility equity, correct?

MR. MEYER: Object to the form of the question, it stated or it characterized that this is a rate payer subsidy, and object to the form of the question, ask that it be reformulated.

MR. FFITCH: I will move on to my next question, Your Honor.

BY MR. FFITCH:

Q. If the consolidated company common equity ratio is about 40% and all of the debt is utility debt but only part of the equity is utility equity, the capital structure that supports the utility operations has an equity ratio that's below 40%, correct?

A. You can do the arithmetic as Mr. Hill did to come to a lower capital structure, but from an investor's perspective the investor is investing in the corporation, and the corporation has 40% equity and 60% debt. Secondly, I think it's very important for the purposes of ROE, the comparable companies we're looking at, the industry generally has a capital structure with much more than 40% equity. So to the extent that we estimate the cost of equity based on industry comparables, as I have done, Mr. Hill and Mr. Gorman have done, we are picking a cost of equity which goes with a capital structure with significantly more equity.

Q. Well, let me try to ask that question again, Dr. Avera. Accepting your characterization of this as simply a mathematical exercise, the capital structure that supports the utility operations in the scenario I have described has an equity ratio that's below 40%, correct?

A. You can calculate a utility only capital structure which is below 40%. I have some problem with your use of the word supports. There is -- you can calculate, the company has done it, Mr. Hill has done it, a utility capital structure which has less than 40% equity.

Q. All right, thank you.

A. But that is not what investors see.

MR. FFITCH: All right, I understand your point.

Those are all my questions, Your Honor.

JUDGE CAILLE: Ms. Davison.

C R O S S - E X A M I N A T I O N

BY MS. DAVISON:

Q. Good morning, Dr. Avera. My name is Melinda Davison, and I'm the counsel for the Industrial Customers of Northwest Utilities in this case. Are you familiar with the settlement agreement in this case?

A. I am generally familiar with it.

Q. Are you the sponsoring witness for the ROE that's agreed to in the settlement?

A. I'm not sure. I recommended or I agreed with in my testimony the company's request for 11.5. In my rebuttal testimony I said that the 10.4 embodied in the settlement was certainly reasonable by comparison to quantitative estimates and other what we see being allowed for other utilities here in Washington for the Puget order. So I testified as to the reasonableness. Now sponsorship, I'm not really sure, we might have to ask Mr. Meyer if that's the correct characterization of my role here.

Q. Well, I guess given your extensive experience in this area, I think the question is pretty clear, either you're the sponsoring ROE witness for the settlement agreement or you're not.

A. Well, I am certainly testifying that the 10.4 is reasonable, and I'm testifying that as I understand it in the context of the stipulation it is beneficial to customers and to the customer -- and to the company, so I am certainly endorsing the 10.4. I think it is a reasonable resolution of this matter.

Q. So if I conclude from your answer that you are, in fact, the sponsoring ROE witness for the settlement agreement, then my question is, why doesn't your name appear on the joint testimony supporting the settlement agreement?

MR. MEYER: Your Honor, I don't believe that that's what the witness testified to. He has indicated and his rebuttal testimony speaks for itself, it speaks to evidence that would support a higher than a 10.4 ROE. That's our witness's expert testimony. Now for settlement purposes it should be obvious that we have agreed to less than what he suggests and his rebuttal evidence would support. The fact that we entered into a settlement agreement at something less than that has been the subject of yesterday's discussion about compromise on a number of issues, and so I don't think it advances the ball much to talk about whether he is sponsoring 10.4. He is sponsoring his expert ROE testimony. It stands as it is. Other witnesses such as Mr. Norwood have talked about the compromises that have gone into the settlement document. Hopefully that clarifies.

MS. DAVISON: Your Honor, I believe that I am entitled to discern who is the witness that is sponsoring the 10.4 ROE that is in the settlement agreement, and that is simply what I am trying to elicit here, and I think that is a very fundamental evidentiary issue in this case.

MR. MEYER: I believe the witness has responded to his comfort level with 10.4 as a settlement figure. We also have Mr. Malquist, our CFO, who will be taking the stand and can shed further light on why the company might have agreed to 10.4. We have already heard testimony from Mr. Norwood to that effect as part of a package.

MS. DAVISON: And I understand that, Your Honor. I'm just simply trying to understand as an evidentiary matter who is the witness sponsoring 10.4, whether it's Dr. Avera or another witness. And I guess I had understood Dr. Avera to say yes, he is sponsoring it. Mr. Meyer has now told me that is not correct. So I'm trying to get to a very fundamental issue here that I think is fairly straightforward.

JUDGE CAILLE: All right, I'm going to ask the court reporter to please read back Dr. Avera's response to Ms. Davison's last question.

(Record read as requested.)

JUDGE CAILLE: Ms. Davison, I believe that that's the witness's answer.

MS. DAVISON: Well, I guess, Your Honor, I don't want to belabor this point, but I am trying to get a yes or no answer from Dr. Avera whether he is the sponsoring witness of the settlement on ROE or not, and I do believe that's a question I'm entitled to get an answer to in a yes or no fashion.

MR. MEYER: If that very question needs to be put to someone, I would suggest that it either might have been put to Mr. Norwood but can still be put to Mr. Malquist.

JUDGE CAILLE: All right, I'm going to ask the witness to please answer Ms. Davison's question.

A. I don't know. I have been asked to comment on the reasonableness of the 10.4, my testimony, my rebuttal testimony I think documents that 10.4 is lower than quantitative indications of the cost of equity. So that's what my testimony does. In terms of sponsorship as it might have a legal or regulatory interpretation here in Washington, I can't say.

BY MS. DAVISON:

Q. Okay, let me try it this way, do you have the joint direct testimony supporting the stipulation in front of you?

A. I do not.

Q. All right. That testimony has listed as the joint witnesses as Kelly Norwood, Brian Hirschkorn, Roger Braden, Michael Parvinen, Hank McIntosh, Joelle Steward, Donald Schoenbeck, and Charles Eberdt. Of those individuals, are you aware of any of them that have credentials sufficient to testify on issues regarding ROE?

A. I'm not familiar with all of the individuals, I have worked extensively with Mr. Norwood, but I can't comment on their relative qualifications to testify on ROE.

Q. Do you believe that the 10.4% ROE in the settlement is sufficient for Avista to attract the capital needed to meet the economic and reliability needs of the company? And if you can answer yes or no and then provide an explanation, please.

A. Yes, I think it does within the context of the stipulation that has other beneficial attributes from an investor's perspective that would allow the company to attract capital. I think the stipulation in my experience, having been involved in many stipulations in many jurisdictions, a stipulation is a total package, it is the result of compromise. And I think the investment community when they look at a stipulation and how it affects their willingness to put capital into a utility looks at all of the characteristics. One of the benefits of a stipulation is the certainty that it brings to the regulatory situation.

Q. Isn't it true in your direct testimony that you conclude that the 11.5% ROE is needed by Avista, "at this critical juncture given the importance of supporting the financial capability of Avista" to ensure that it can attract the capital necessary for providing reliable service?

A. Yes.

Q. Do you know how the parties derived the 10.4% ROE?

A. I was not present. I have talked to Mr. Malquist about his participation, I have talked somewhat to Mr. Norwood and Mr. Falkner about their participation. My understanding was there was a give and take over a period of days when different parties made different offers. And at the end of all of this process, the stipulation was agreed to by the company and some of the parties, which incorporated the 10.4 along with a number of other characteristics. So it was a negotiated settlement that involved give and take. I understand that it evolved over time as these things do, but I was not present, and I think if you want to know exactly how it may have evolved, Mr. Malquist would be the person that can tell you.

Q. Is it correct that your testimony does not actually support a 10.4% ROE?

A. My testimony demonstrates I believe that 10.4 does not exceed the cost of equity for Avista at this time and that the arguments that are raised by Mr. Hill and Mr. Gorman to change the stipulation for a lower return or for a different capital structure or including restrictions on dividends are misguided and would alarm the investment community and be contrary to the interest of customers.

Q. Would the investment community be alarmed if the ROE, let's say the Commission decided to adopt a 10.25% ROE, would that alarm the investment community?

A. Well, I think to the extent that the 10.4 is out there, it has been commented upon, I think if this Commission were to change a material characteristic of the stipulation, and I think the ROE is a material characteristic, I think that would be alarming. Now I think a 10.25 change would be less alarming than a 9.8 or a 9.25 as Mr. Gorman and Mr. Hill propose, but I think any change from the stipulation would be a matter of focus by investors, and how they react would depend on how large the change was and if there were any other offsetting changes made to the stipulation.

Q. Was the investment community alarmed when Avista decided not to pursue your 11.5% ROE and instead agreed to 10.4% ROE?

A. Well, I think the investment community always favors certainty, and I think the fact that the stipulation seemed to bring certainty was a favorable attribute that offset I think the fact that 10.4 was a lower number than they may have hoped for from a litigated case. So I think the investment community looks at the whole situation, the adjustments to the ERM, the certainty that it brings to the regulatory environment at this crucial time for Avista, so I think the stipulation has been viewed by the investment community, in one of the cross exhibits is the recent Standard & Poor's report, has been viewed as a positive because it does resolve uncertainty.

Q. Dr. Avera, isn't it correct that the 10.4 does not resolve any uncertainty at all until the Commission decides to adopt an ROE number in this docket?

A. I think that's true. I think the investment community generally feels that when the Staff and other interveners and the company reaches a stipulation that there is a good probability that it may be accepted by the Commission. That has been the experience in other stipulations. I think the investment community is mindful that the Commission does have an obligation to review settlements and find them to be in the customers' interest, so I think investors know that the Commission will have the last word. But I think when a stipulation is reached that involves a number of parties, especially the Commission Staff, I think the investment community regards that as having some significant impetus toward being approved. But they know that the final world rests with the Commission.

Q. Turning back to the settlement agreement and the 10.4% ROE, am I accurate in concluding from one of your previous answers that basically that's an agreed upon number that isn't supported by workpapers or mathematical type equations, that it was just simply a compromise position; is that correct?

A. It is a compromise position, but I wouldn't say just a compromise position. The compromise was reached after substantial testimony was filed, after the Staff and the other parties had the benefit of seeing the company's testimony, including my direct testimony. So the stipulation is not done in a vacuum, it's done in the context of a great deal of information, information about this case, information about the Commission's recent order in the Puget case and in other cases, information about what's happening in other commissions. So I think the give and take that occurs in a stipulation is informed by all of this information, my direct testimony, the other company testimony, and information about capital markets and regulations generally.

Q. You appeared as Avista's cost capital witness in the 1999 general rate case before the Washington Commission; is that correct?

A. Yes, it is.

Q. Do you recall that the Commission refused to adopt your multistage DCF analysis because it was not supported by sufficient factual foundation?

A. It breaks my heart, but I remember some language like that, so. I thought at the time that the multistage did reflect how investors may be looking at utility stocks, the Commission found otherwise.

Q. Doesn't the Commission's concern in 1999 present itself here with regard to the settlement adopting the 10.4% ROE in that there is no factual support to demonstrate that 10.4% ROE versus 10.3% versus 10.2% is a reasonable number?

A. No.

MR. MEYER: Object to the form of the question. The form of the question again assumed, well, assumed explicitly that there was no factual support for the 10.4%, and I believe this witness has already testified that there is evidence in the record suggesting an even higher ROE would be appropriate and that the 10.4% was a negotiated position, so object to the form of the question.

JUDGE CAILLE: Any response, Ms. Davison?

MS. DAVISON: Well, I think we have had this dialogue back and forth, so I think Dr. Avera and I have a common understanding, but I mean if you would like me to rephrase it, I can.

JUDGE CAILLE: Would you, please.

BY MS. DAVISON:

Q. Understanding that the 10.4% ROE is a compromise position that does not have a workpaper behind it supporting its calculation, doesn't the Commission's concern expressed in the 1999 order also present itself here?

A. No, it does not. And the reason it does not is because, first, cost of equity I think as recognized in the 1999 order is not a precise number that we can find in some publication or by some experiment. It is a judgment call that we can only indirectly infer from marketplace information. I describe in my direct testimony that the cost of equity must be inferred from indirect evidence, either equity market evidence using the DCF or debt market evidence using the risk premium or CAPM methods. So at best we can come up with a range of reasonableness for the cost of equity, and I think that's what this Commission has done in other cases as I have read recent orders as well as the 1999 order.

Now that range though is informed by evidence. We have evidence from the capital markets. We know what market prices have done, we know what risk measures like bond ratings like Standard & Poor's business position indicators are, we know what Betas are, we know what Value Line says, we have lots of information about the relative risk of the company and investor requirements. And using that information, we can develop a reasonable range for the cost of equity.

I have developed a reasonable range in my direct testimony. I think the 10.4 falls within that reasonable range. So I think there is plenty of information that we can apply to estimating a range for the cost of equity, and I think that was available to the parties when they were negotiating the stipulation.

Q. The Commission stated in the 1999 order:

If meeting the burden of proof through

opinion testimony has any meaning, it means that the witness must present a logical connection between the factual evidence presented and the opinion offered.

Is it your testimony that your direct testimony in this case supports the 10.4% ROE?

A. Yes, I think it is factual information about various indicators of Avista's relative risk, indicators about what investors require from stocks and bonds of similar utilities, and I think that information is factual. I think it supports my expert opinions, so I think the Commission has available to them information that they use. In 1999 the Commission chose not to consider the multistage DCF, it did consider other forms of the DCF and other forms of the risk premium. I think those are presented here.

Q. Let's assume hypothetically that the Commission decides not to adopt the recommendations or the testimony that you sponsored in this case, as they did in 1999, what testimony is left in the record then to support the 10.4% ROE?

A. Well, I think my rebuttal testimony where I look at the analyses that Mr. Hill and Mr. Gorman have done and explain how they are biased downward and explain how certain things were ignored or certain things should be considered to increase the estimates that these gentlemen present. I think that evidence even if you completely ignore, as I don't think you should or the Commission should, my direct testimony, I think the rebuttal testimony based on my analysis of what the intervener witnesses have presented supports the 10.4.

Q. But you would agree through your years of experience that neither ICNU nor Public Counsel have the burden of proof on this issue, would you not?

A. Well, again, you're asking me a legal question. My understanding from my 35 years of participation in the regulatory environment is that the company generally has the burden of proof, although I'm trying to think about when you have a stipulation and there are parties who are objecting to the stipulation, I think they have some obligation to come forward with evidence of their objections.

Q. I would like to explore a subject that Mr. ffitch covered briefly with you, and that is the settlement agreement assumes that Avista has 40% equity; is that correct?

A. That is correct.

Q. And it's true that the 40% equity includes investments in Avista's unregulated operations; is that correct?

A. Well, the 40% equity is first representative of the consolidated equity which includes the utility as well as other operations. It is also well below what the comparable companies in the utility industry generally have as an equity ratio.

Q. Let me try my question again, it really is a yes or no question. Isn't it true that the 40% equity includes the investments in Avista's unregulated operations?

A. No, the 40% is a number that's in the stipulation. Now Mr. Hill said in his testimony it happens to be the same as the consolidated capital structure. Mr. Hill is very clear in his testimony that he recommended 40% not because it was the consolidated capital structure but because it was representative of the industry. So the 40% is 40%. Now it happens to be close to the consolidated capital structure, it happens to be on the low end of the industry. It is a number that is used to calculate a revenue requirement and a weighted average cost of capital, but the 40% is 40%.

Q. Do you agree with Mr. Gorman that the correct level of equity for the utility operations of Avista is 27%?

A. The correct, you mean --

Q. The actual.

A. The actual, I would agree that if you do the arithmetic, and I think, I don't remember exactly what time period Mr. Gorman did it, but if you do the exercise of assigning the debt to the utility and then break out the equity, you get something in the neighbor, you know, under 30% historically. It's moving up.

Q. Do you agree with Mr. Gorman's calculation that if you use 27% equity that the 10.4% ROE translates into 12.88% ROE?

A. No, I don't agree with his reasoning, because the 10.4 is based on a 40% capital structure, which I think is a reasonable capital structure, so I think the 10.4 is 10.4.

Q. Right, but for purposes of my question, it is another what you would call a calculation question, which is if, I understand that you don't agree with the assumption in the question, but assume for purposes of the question that you use a 27% equity and you do the math, do you disagree with Mr. Gorman's calculation that that translates into a 12.88% ROE?

A. The calculation results in -- I haven't looked at the -- I know Mr. Gorman to be an engineer, and engineers don't usually makes mistakes about things like this, the calculation results in 12.88, but that is to the allowed return, the allowed return is 10.4.

Q. I understand that's your position.

In February of this year, the Washington Commission issued an order involving Puget Sound Energy. This was a case in which the cost of capital issues was very prominent. Have you had occasion to read the Puget decision?

A. I have, I have it with me.

Q. Are you aware then in the Puget case that the Staff's cost of capital witness, Dr. Wilson, opposed giving Puget an equity ratio based on what was termed phantom equity costs?

A. Yes, I read that that's what John said. That's a term I have heard him use many times.

Q. The Commission concluded in the Puget case that the correct outcome was to exclude the negative equity of PSE's unregulated subsidiaries so as to isolate and focus on the regulated utility operations; do you recall that?

A. I don't know if I agree with your characterization. They chose to look at the utility and assign a utility capital structure, which was I believe 43% or 45%. I have to refresh my recollection about what the finding was in terms of what they allowed.

Q. Well, if you turn to page 17 of that order, about midway through you see a statement from the Commission that says that:

We modify Staff's approach as supported by Dr. Wilson's analysis by applying that approach to the actual 12 months of the rate year and by excluding the negative equity of PSE's unregulated subsidiaries so as to isolate and focus on the regulated utility operations.

Do you see that?

A. That's correct, and then the next sentence has the 43% that I remember.

Q. That's correct. If the Commission were to adopt the 40% equity level here in the settlement agreement, wouldn't that decision be at odds with the Commission's very recent decision in the Puget case?

A. No, I think it would be consistent. Because in the Puget case, you have a utility with a higher bond rating in a case when interest rates were significantly lower than they are now, and you allow a 10.3 with a 43% equity. I think allowing a 10.4 with a 40% equity for a utility that's demonstrably more risky in a higher interest pie and rising interest rate environment, I think 10.4 is certainly consistent with the 10.3 allowed in February.

Q. Did you review Avista's 10-Q which is dated August 5, 2005?

A. I probably -- I don't have it with me, but I reviewed a number of their 10-K's and 10-Q's if you would -- so I may have, I don't have it with me. That's not one of the exhibits, is it?

Q. No, it's not. We'll try to -- I have some general questions and we'll do it subject to check, and I think we can get through without trying to disrupt the --

MR. MEYER: I think it would be helpful though if my witness could have a copy of that in front of him.

JUDGE CAILLE: Ms. Davison, do you have a copy that the witness could use?

MS. DAVISON: Well, that was my point earlier when I mentioned to you that I only have my one copy. I can make copies, we can take a quick break and I can make copies or --

MR. MEYER: I have a copy here I can hand -- we were able to get one from our files.

JUDGE CAILLE: Thank you.

MR. MEYER: Let's make sure it's for the right period, again what period was that?

MS. DAVISON: It is filed on August 5, 2005, for the period ending June 30, 2005.

MR. MEYER: That's it.

BY MS. DAVISON:

Q. Is it correct subject to check that Avista's net income increased from $19.9 Million in 2004 to $37.4 Million in the six months ending June 2005?

MR. MEYER: Can you give us a page and a --

MS. DAVISON: Page 41.

A. So the numbers you were referring were what, please?

BY MS. DAVISON:

Q. My question is, isn't it correct subject to check that Avista's net income increased from $19.9 Million in 2004 to $37.4 Million in the six months ending June 2005?

A. Well, I don't see that quite yet, but I will accept it. I mean if those numbers are derived from this page, I will accept it for present purposes.

Q. Avista's 10-Q shows that the regulated operations are having significantly improved earnings while the unregulated side is suffering losses; isn't that correct?

A. Well, I think it mentions a net loss of $.3 Million for energy marketing and resource management.

MR. MEYER: Your Honor, if it would be of some assistance, we have a following witness this morning, Mr. Malquist, our CFO, who to the extent that we're going to go much beyond the questions here on the 10-Q would be perhaps a better witness to speak to that.

MS. DAVISON: Well, I'm certainly happy to ask Mr. Malquist these questions, but I also think that very, very basic questions about the earnings of Avista would be something that Dr. Avera would have looked at and would be informed to talk about.

MR. MEYER: But these are not very, very basic questions, these are specific questions about specific figures in an exhibit that he's just now refreshing his recollection on.

JUDGE CAILLE: Well, I don't think it's an exhibit actually yet.

Perhaps we could defer these questions to Mr. Malquist and you could have an exhibit ready for the Bench and Mr. Malquist.

MS. DAVISON: Very well.

BY MS. DAVISON:

Q. I would like to follow up though, there was a point that you made in responding to Mr. ffitch's question about this equity issue, and you stated that you believed something to the effect that rate payers were significantly benefiting from this consolidated capital structure; is that correct?

A. I believe rate payers get the benefit of the equity that the consolidated capital structure has, because I think they look to that in terms of the security for the bonds, and there is also the benefit of diversification that comes from having other businesses. I think there have been times when the utility was having difficulty and the other businesses were able to furnish significant cash. I understand that the energy marketing has been a source of significant cash over the last several years. Looking at the Standard & Poor's review of Avista, there is discussion of the benefits of the energy marketing. So I think customers do benefit from the total corporation.

Q. Is it your testimony that customers are currently benefiting from Avista's $257 Million invested in equity in the unregulated businesses that have a year to date loss of 17 cents per share?

A. Well, I think the investment community obviously looks to the future, and they realize that circumstances come that generate losses in the energy operation and other circumstances the energy operation is generating gains. And that is the essence of diversification, that you don't have all of your eggs in one basket, and when the utility is under stress, the energy marketing operation can provide cash flow and resilience. Conversely in a circumstance like the recent six months where the energy has not been as profitable as it had been the last several years, the utility is there. That's the nature of diversification, that one business is doing relatively well while another business is doing relatively poorly.

Q. I understand that that's your position, but my question was very specific. My question was whether today based on this $257 Million in equity in the unregulated businesses that have a year to date loss of 17 cents per share whether today rate payers are benefited by that?

A. Yes, and my answer is yes because rate payers are insulated from the losses of the unregulated subsidiaries. That doesn't change their rates, but they get the benefit of the equity and the benefit of diversification when Avista has to go to the capital markets to raise money or to refinance their debt. So customers today are benefiting because of the corporate structure that creates financial resilience, that the customers know that their utility will be in a position to raise capital going forward.

Q. But isn't it true that the only way that customers are really benefiting from this high level of equity investment in the unregulated operations is if the unregulated operations provide cash flow?

A. No. On a month to month, quarter to quarter, six month to six month basis, they will provide cash flow or not depending on the business conditions of the individual businesses. The benefit to the customer is that the entity of Avista Corporation is better able to weather storms like it had to weather in the last several years in the power supply markets and whether it is able to access capital markets on a reasonable basis. And in those terms, the equity invested in the unregulated businesses is a benefit to customers.

Q. Dr. Avera, are you familiar that Standard & Poor's specifically evaluates the cash flow that is being generated from these operations when it issues its ratings?

A. Yes, Standard & Poor's uses what's called a consolidated approach to bond ratings where they look at the parent's businesses and consider the characteristics and the risk of all the businesses in determining the ratings that they assign to the securities issued by the company. So Standard & Poor's considers the unregulated businesses as well as the regulated businesses when they assign a bond rating to Avista securities.

Q. So if the unregulated operations are not making money, they have no cash flow coming in, they are not in effect supporting the credit rating that Avista currently has; is that correct?

A. That is not correct. The bond rating agencies are sophisticated. They know that month to month, quarter to quarter, even year to year different businesses experience good times and bad times. The bond rating agencies, and Standard & Poor's in its bond rating guidelines goes to great extent of they take a long-term view of looking over the course of several years into the future. Because they have an awesome responsibility to investors, people who are investing in the securities, mutual funds, insurance companies, foundations, government agencies rely on those bond ratings when they're putting real money into real bonds. So the bond rating agencies say, let's take a long-term view of what the risk and prospects of the company are. So they don't look at one quarter or one year, they take a long-term view, and in that long-term view they see the benefit of the equity in the unregulated businesses.

Q. Well, if you turn to ICNU Cross Exhibit 67, that actually isn't correct, is it, Dr. Avera? If you turn to page 3 of that exhibit under the outlook, doesn't Standard & Poor's actually say that the stable outlook assumes that Avista will continue to aggressively pay down debt and avoid making further capital investments in unregulated businesses?

A. That is correct, but it assumes that the profile is not going to change. But then it talks about all of the factors in the next sentence that affect the future ratings and such things as the financial ratios that are currently weak. Well, to the extent that the unregulated businesses contribute to the financial ratios, that is a positive from Standard & Poor's perspective.

Q. Well, except if you read the last sentence of this ratings report, it says:

> Given the relatively stable nature of utility cash flows, downside risk is limited mainly to substantial losses at Avista Energy.

Isn't that correct?

A. That is correct, that is the nature of the energy business versus the utility business. The energy business has more variability. It has downside losses and it has upside gains. The utility business is more stable. When you combine them together in a portfolio, you have a more stable portfolio.

MS. DAVISON: I have no further questions.

JUDGE CAILLE: This seems an appropriate time for us to take our morning break. How about if we come back at quarter to 11:00.

(Recess taken.)

JUDGE CAILLE: I believe we have completed the cross-examination of Dr. Avera by the parties, and, Mr. Meyer, do you have redirect?

MR. MEYER: I do, Your Honor. During the recess, I distributed a 1 page item that I would propose to mark as Exhibit 75. I believe that's a reserved number, and this would be the omitted page from the Roger Morin exhibit, Exhibit 74, that had been referenced earlier, and I would propose therefore that we mark page 250 from the excerpted text which I distributed as Exhibit 75.

JUDGE CAILLE: It is so marked.

Is there any objection?

MR. FFITCH: Your Honor, we don't have an objection, Public Counsel, we submitted 74, my only offer would be that we would be happy to have it be included with the immediately preceding pages and just be part of Exhibit 74, but we'll abide by whatever your preference is.

JUDGE CAILLE: Since it's just following, let's keep it at 75, thank you.

MR. MEYER: Thank you.
And ask that that be admitted.
JUDGE CAILLE: And that is admitted into the record.
MR. MEYER: Thank you.

R E D I R E C T E X A M I N A T I O N

BY MR. MEYER:
Q. Just a follow-on question then relating to that newly admitted Exhibit 75, you had referenced certain critiques of the market to book analysis, and those were set forth at the bottom of the preceding page, 249, which is part of Exhibit 74, and it continues on to Exhibit 75, correct?
A. Yes.
Q. Just for the record, would you just briefly reiterate what the primary critiques were?
A. Yes, the first critique is that there is a mismatch between the market to book that -- and when I teach this, I put up market to book and on market I point an arrow forward and on book I point an arrow back. Because what Professor Morin is saying, the market value depends on the future, what investors are buying is the future, so they are projecting what the future returns will be, not what the present or past

returns will be. The book value is an accounting number, accounting are historical numbers, so they're looking backward at what the assets are valued at as original cost. So there's this mismatch between the time frame of market value and book value.

The second observation that Professor Morin makes that why you can't apply the market to book approach is that the allowed return does not equal the return that the company will actually be expected to earn, because there are many other things that go into the regulatory framework, disallowances, things like in this case the deadband around the ERM, those affect what the company will actually be able to earn in addition to the specific allowed ROE.

The third observation is there are other factors that affect the future earnings of the company, especially a company like Avista where you have other activities under the corporate umbrella. You have the energy activities. When investors are setting the market value, they crank in expectations about these other activities as well as the utilities, so they're mixed together in market value.

And then finally there is the issue of inflation. Because book values are measured on historical bases and we live in an increasingly inflationary economy, the relevant asset values are generally higher than book value. So if we look to market book relationships, book is not measuring what our true asset values are, so there is a mismatch there.

So those are the four reasons that Professor Morin says that in theory the market to book follows, in practice it does not.

MR. MEYER: Thank you, and that completes my redirect.

JUDGE CAILLE: Chairman Sidran?

E X A M I N A T I O N

BY CHAIRMAN SIDRAN:

Q. Dr. Avera, I understand you conducted your analysis in the January-February 2005 time frame, and you have testified here today and in your filed testimony about investor expectations of the future. I would like to ask you if the course of events since you did your analysis, $3 a gallon gasoline, the hurricanes in the Gulf Coast, the passage of the Federal Energy Policy Act, whether those factors and the performance of the stock market since the first of the year in terms of returns of market overall versus returns of the utility sector, whether those factors would in any way change your opinion in relationship to your analysis, and if so, how?

A. Well, I think those factors in total generally argue toward higher required rates of return. I think the energy cost is what's driving inflation. The expectations of inflation is what's driving the expectations of higher interest rates. The discontinuity that the hurricanes and the events in the world have created I think have increased the general level of uncertainty. I think the Energy Act, although it has many favorable features for the utility industry, is an element of risk because it's not exactly clear how the new Energy Act will be implemented. In fact, in their August edition, the Value Line for the Western utilities talks about the extra risk that the Energy Act imposes on utility investors. So I think on balance between February and January, which are the numbers reflected in my direct testimony, we're looking at a likelihood that required returns if anything have increased and certainly not appreciably decreased.

What we have observed earlier in the period utilities were relatively strong, they were outperforming the market, but in recent weeks utilities have been relatively weak. For example, Avista in August was close to $20 a share, yesterday it closed at $18 a share. I think many other utilities have similarly experienced revaluation downwards in the last several weeks as these uncertainties have become more manifest. So that's why I didn't feel a need to specifically revise my opinion, because my direct testimony indicates that returns are generally significantly higher than 10.4, and I think events since then just strengthen that conclusion.

CHAIRMAN SIDRAN: Thank you.

JUDGE CAILLE: Any other questions?

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Good morning, Dr. Avera.

A. Good morning, Commissioner Jones.

Q. Just like to go back to parts of your rebuttal testimony if you could. I'm sure you have it in front of you.

A. Yes, sir.

Q. This follows on the Chairman's question on changes during 2005, and I just want to confirm for the record that you, since you submitted your original prefiled direct testimony, that you stand by the conclusions on ROE stated in that direct testimony, and that reflects the conclusions for your cost of equity estimates using four approaches as stated an page 44 ranging from 11.5 to 11.8, well 12.6% on the cost of equity estimates.

A. Yes, sir, I think that those are still operative in today's environment.

Q. Has there been anything that would cause you to revise upward or revise downward those estimates, and, well, please address that one first.

A. Well, I think the interest rate environment has become one of greater upward pressure. I think the continued action by the Federal Reserve to raise short-term rates, I think there have been five increases since I originally filed my testimony. Initially long-term rates did not respond, but more recently they have. I think if you look at and as investors look at the federal budget deficit created by the cost of the war in Iraq and the rebuilding of the Gulf Coast from Katrina and Rita, I think the interest rate environment has gone higher. And while cost of equity do not move in lock step with interest rates, I think they move generally in the same direction. So the fact we're moving into a higher interest rate environment would suggest that the cost of equity is also trending upward.

Q. And on that point, do you generally believe that GDP growth is also on an increasing path, that the Fed is looking at increasing rates of GDP and tightening down on monetary policy in order to --

A. I certainly think so. The minutes that have been released of the recent meetings suggest that the Feds think that the dislocations from the hurricanes has been temporary and that in fact as we move into 2006 the rebuilding will create a demand drive to higher levels of GDP growth. So I think that would cause the Fed to err on the side of tightening monetary policy, because they think inflation is the greater risk than economic weakness.

Q. Would you turn to page 4 of your rebuttal testimony, and I would just like to confirm that you stand by the statement there where you say:

> Do the interveners' ROE recommendations meet the threshold test of reasonableness required by established regulatory and economic standards governing a fair rate of return on equity? Based on the evidence discussed subsequently, the answer is clearly no.

Do you still stand by that statement even after -- and for the record you have in your rebuttal done an extensive analysis of Mr. Hill's testimony and Mr. Gorman's testimony, correct?

A. I have, and I believe that the problems that

I point out with their testimony and the downward bias is sufficient to convince hopefully the reader that their 9.25 and 9.8 respectively do not meet the Hope and Bluefield Test, would not be sufficient to attract capital and maintain investor confidence, and are not equivalent to returns of comparable risk.

Q. So when you talk about the test of reasonableness required by "established regulatory and economic standards," you're referring primarily to Hope and Bluefield?

A. Yes, sir, I am, the three, capital attraction, comparable earnings, and financial integrity.

Q. Elsewhere in your rebuttal testimony you quote that there is a small minority of utilities that still belong to the below investment grade status for unsecured credit, a corporate credit rating. Could you give us an idea by percentage or number of utilities, of course you didn't use any of those in your proxy group, did you?

A. No, I did not. They were specifically excluded, and I think we're probably talking seven or eight that are below investment grade. Some of them are relatively small, but certainly we have West Star, Sierra Pacific, El Paso Electric recently regained

investment grade status, did I mention West Star is below, so presently we're probably in the seven or eight of which Value Line may follow four or five.
Q. And that is out of how many publicly listed electric and gas utilities in the United States?
A. Well, publicly traded, major publicly traded are probably 130, and I believe about 67 are followed by Value Line, so we're talking less than 10%.
JUDGE CAILLE: Excuse me, just for the record, Commissioner Jones's questions have been referring to Exhibit 62, which is the rebuttal testimony of Mr. Avera.
COMMISSIONER JONES: Thank you, Judge.
BY COMMISSIONER JONES:
Q. Back to the market book line of questioning, I must admit I have a difficult time getting my head around this issue of the price of an asset, a utility stock if you will, and the market capitalization and the relationship to ROE, and I have read several documents that indicate there might be a correlation between market to book and ROE if you observe that over a significant period of time, going back historically of course is what I'm referring to. Have you ever observed that there is a correlation, if any, between an M/B and an ROE ratio actually earned? This is an actually

earned ROE for a publicly listed utility.

A. Well, I think in the past when utilities -- when utilities were more homogenous and they were largely regulated and expected to remain regulated, let's say in the late '70's and early '80's, there was a general correlation, very rough, but a general correlation between the allowed and earned returns and the market to book ratio. Generally during that period market to book ratios were less than 1 because you had the nuclear issues and rapid construction, and that was a time of energy price fly up as well. So during that period of time, there was a very rough correlation. Since then I don't think the correlation has held up, because a lot -- the utility business has become a lot more complicated, you don't have pure play utilities any more, and the environment has become more dynamic.

Q. Could you turn to page 16 of your testimony, your rebuttal.

COMMISSIONER JONES: Judge, that's 62.

JUDGE CAILLE: That's 62.

BY COMMISSIONER JONES:

Q. This gets into the issue of dividend taxation.

A. Correct.

Q. And as we all know, Congress changed the law on dividend taxation to lower the long-term capital gains rate on "qualified dividends" to 15%; is that correct?

A. Yes, sir.

Q. Speaking generally, don't you, I understand your testimony here that you list two reasons why this may not have an impact on the investors' required rate of return, but just on its face, doesn't this increase the attraction of higher dividend paying stocks such as utilities?

A. It certainly does for taxable investors, and I think it was a significant event. But I think in terms of how it affects the methodologies and the application of the methodologies, to determine the cost of equity you have to consider that first a large number of the investment dollars and certainly the marginal dollars are from non-tax paying accounts, individual retirement, 401-K, pension, and profit sharing, that's a predominant amount of the marginal investment. For example, in mutual funds 60% of the new funds flowing into mutual funds is nontaxable accounts, and they only account for 24% of the total nontaxable accounts in the economy. The total nontaxable accounts are probably $9 Trillion at present. So there's a nontaxable issue, and then there's also the fact that this change had been largely anticipated and is reflected in the market prices we use for example in the DCF model.

Q. So have you incorporated that change in dividend tax policy both in your forward looking CAPM approach and in the DCF approach that you used in your prefiled direct testimony?

A. I believe I have, because in those cases I used the observed market prices of in the DCF utilities stocks and in the forward looking CAPM the stocks in the Standard & Poor's 500, so those market prices reflect what investors are considering when they buy and sell the stocks. So to the extent that the dividend tax cut is relevant to investors, it is reflected in those market prices.

Q. Can you quantify at all the impacts in percentage points in basis points that this has had either in the -- I think for the DCF you estimated a 9.8%, is that correct?

A. That's correct.

Q. And in your forward looking CAPM you estimated 12.6%, correct?

A. Yes, sir.

Q. Would roughly 50 basis points of that be attributable to this change in dividend policy or not; do you have any estimate on that?

A. I would hate to hazard an estimate while I'm here on the record.

Q. Okay.

A. Yeah, I don't think it's a big number, I think we're talking basis points, not hundreds of basis points.

Q. I understand.

A. There's been a lot of academic research. In fact, Merton Miller, who is one of the Nobel Laureate, did a tracking on death and taxes where he basically reached the conclusion that it's extremely difficult to quantify the tax effect in the capital markets, because you have this mixture of taxable and nontaxable investors.

Q. Referring to your forward looking CAPM approach, can you explain to me why you use the S&P 500 estimate of earnings as the basis for your earnings growth? I think the number you use in both forward looking and backward looking CAPM is 12.1%?

A. Well, I think I use a higher -- the 12.1 in the forward looking is based on the bottoms up IBIZ numbers estimates, and let me explain why first I used the Standard & Poor's 500. I used the Standard & Poor's 500 for both the forward looking and backward looking. The Standard & Poor's 500 are the 500 largest companies by market capitalization in the economy, Exxon being right now the largest, General Electric, General Motors, et cetera. These represent the bulk of the market value of the total stock market. The theory of the CAPM is that you should use a market basket of all the stocks. Well, that is hard to measure all the publicly traded stocks. If you take the 500 largest, you've gotten the bulk of the -- accounted for the market value.

Now there's another reason in the forward looking to use the Standard and Poor's 500, and that is those companies are the ones that are most widely followed by professional investment analysts. And what we did to estimate what investors required from those companies is we went to each of those 500 companies and what the analysts that follow those companies are projecting for five years earnings growth rates. So we're using literally thousands of expert opinions of analysts, you know, the analysts who devote their lives to following General Motors or devote their lives to following General Mills or Microsoft or Dell, and their best estimate of the growth. So by using the Standard & Poor's 500, we have a very rich set of data involving lots of independent analyst inputs, so that's why I thought it was the best approach to get an estimate of what investors require for the total market.

Q. So that is significantly different than the comparable earnings approach or looking back on historical growth rates for utility firms when you look at a proxy group of utilities, correct?

A. This is correct, we're looking at a group of the 500 largest companies by market capitalization, and we're looking forward. We're looking exclusively at the earnings projections that those analysts who specifically follow those companies have submitted.

Q. And it's based on earnings, it's not based on dividend yield, it's based on total earnings expected?

A. That is correct.

Q. Future looking?

A. Because that's the magnitude that investors focus on. And as I explain in my testimony, the research on investment behavior suggests that investors focus on earnings, because it is earnings that form the ultimate ability for stockholders to get out cash either in dividends or in capital gains.

Q. What would be the general impact if you do testify, which you have, that we are in a generally rising interest rate environment, the long-term treasury bond yield by definition would go up I would think, what would a rising interest rate environment if you had to redo the calculations today have on these estimates of cost of equity, the four plus the DCF that you have provided?

A. Well, in terms of the risk premium, I have my notes here, I used a 4.6% 20 year treasury for the CAPM. The current treasury is 4.77, so that's basically 17 basis points higher. It's projected to go even further. So the way the CAPM works, every basis point change in the interest rate is a basis -- translates to a basis point change in your cost of equity estimate.

For my risk premiums I used a B double A bond yield of 5.95. The most recent is 6.12. That's -- it happens to be another 17 basis point increase, so that 17 basis point increase would translate directly into the estimate of the cost of equity from those risk premium approaches.

Now for the DCF, it is not so simple, because the DCF you don't look specifically at interest rates, you look at stock prices and dividend yield and apparent growth rates. But what we do know is that for the utilities generally the stock prices have been weak in the last several weeks. As I mentioned, Avista has gone from around 20 to around 18. We have similar drops for other utilities. Since utilities are what are called interest rate sensitive stocks, higher interest rates are generally bad for the utilities, and utility equities generally drop as interest rate expectations increase and vice versa. So while I haven't redone the DCF's, my belief is that we would have lower prices and therefore higher dividend yields across the board, which would suggest higher DCF results.

Q. In your rebuttal testimony you quoted a study that I haven't seen before in any financial literature, and that's CA Turner, and I think it was in the context of looking at Mr. Gorman's comparable proxy group where you were examining the authorized ROE and came up with a 10.95% number; is that correct?

A. Yes.

Q. You quoted, can you just tell me who CA Turner is and how widely used they are, because I'm not familiar -- I'm familiar with Value Line and Standard & Poor's and groups like that.

A. Well, CA Turner is a service that's been around a long time. It is very specific generally to the utility area, and it was a service that was subscribed to by utilities management, particularly of smaller -- it has extensive coverage of say water utilities that are not covered by Value Line. So it has a lot of information on smaller companies. It has recently been purchased by AUS Utilities or Associated Utilities Services, which is a consulting firm, which is trying to increase its profile in the community.

My experience with CA Turner, I do not use CA Turner in my work because my experience is that a lot of the numbers are hard to reconcile. As I mentioned in my rebuttal, Hawaii Electric, CA Turner reports a capital structure that is demonstrably different from what you derive from the 10-K reports. So it's a service that some experts in this field use, and it is especially useful when you have a small company that isn't covered by Value Line or the larger publicly available services.

Q. This is my last sum-up question, could you just describe, you have taught finance for many years and regulatory economics, when you teach your students about regulatory economics, you must describe the strengths and weaknesses of each of these approaches, CAPM, DCF. Since DCF has been traditionally used by commissions across the country, not exclusively but in many cases, can you, and as a new commissioner, could you just describe the strengths and weaknesses of the DCF approach. I think in one part of your testimony criticizing Mr. Gorman's, Mr. Hill's analysis, you called it "a blunt instrument" or something to that effect, but could you be a little more specific and talk and summarize briefly.

A. The DCF has the great benefit of being simple and straightforward because I think most people are familiar with the concept of a dividend yield, and they're familiar with the concept of a growth rate. If you watch CNBC for 15 minutes, you will hear those terms over and over. So it uses two very familiar terms to construct a cost of equity estimate, so it has the benefit of being familiar, I think it has the benefit of being transparent. I think commissions when they're evaluating testimony or they're reaching conclusions can kind of break it down and say, let's talk about the dividend yield portion and how each witness did dividend yield and who we agree with most, and let's talk about the growth rate and how each witness did the growth rate and which ones we agree to. So it's extremely well suited for a regulatory setting, an administrative setting where you have to have findings of fact and you have to have transparent decisions.

The disadvantage of DCF is that it is largely driven by an unobservable magnitude, which is what investors expect in terms of growth when they pay $18 for a particular stock. There's no place we can go for the definitive non-controversial answer to that question. What we have to do is kind of put ourselves in the moccasins of investors and think like investors think and read what investors read, look to places like

Value Line that we know investors pay a lot of attention to, look to things like the IBIZ growth rates that we know investors pay a lot of attention to, look to historical track records that we know investors look to, and then try to replicate what investors are thinking.

Now the DCF works tolerably well most of the time, and it worked especially well historically in the utility industry where it was a relatively stable industry where growth was pretty much driven by regulatory decisions. I think the DCF served regulators well, and as I grew up in the regulatory world I relied heavily on the DCF both when I was on the commission and as an expert testifying before commissions. I think as we move through time and the world has become more dynamic, pure play utilities have become the rarity rather than the predominant mode of operation, I think the DCF has become harder and harder to apply. So I think these other methods have become increasingly important. It's not just a check of reasonableness but also an alternative when you have reasonably the DCF is giving unreliable results, high or low. So it is a good first start, but it must be accepted carefully and in light of an informed look at what's going on in capital markets.

COMMISSIONER JONES: Thank you, Judge.

JUDGE CAILLE: All right, anything more for this witness?

COMMISSIONER OSHIE: Yes.

JUDGE CAILLE: Commissioner Oshie.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Commissioner Jones had a few more questions than I did, so I thought I would let him go ahead of me. I just have a couple areas of questioning, Dr. Avera, and I guess first I want to talk to you about the capital structure and some of the testimony that you have given here this morning as to the benefits that the rate payers receive from imputing the capital structure of the corporation to the utility. And if I remember your testimony correctly, that there were two benefits that you at least observed and have a judgment, have made judgment about, which is one is that imputing the corporate -- the capital structure of the corporate entity to the utility brings diversity to the corporate structure, which is an overall benefit since the marketplace looks at the corporate entity, not just the utility, and because there's additional equity in the affiliate companies, that that equity is then imputed back to the utility in instruments that are either purchased or sold in the marketplace. Now am I -- and this is a general understanding of your testimony.

A. Yes, sir, that is correct.

Q. Okay. Now if we were to accept that, that there are benefits that inure to the rate payer as a result of the diversity of the corporation and the capital structure, essentially the actions of the affiliate and the performance of the affiliates, if we accept that proposition that that's a benefit to the rate payer, do we also have to accept the corollary or perhaps the converse that if those affiliates do not perform in a manner that the marketplace finds attractive and that it drives the ratings of the company or the equity of the company down, should the rate payers as a result have to bear the risk of that?

A. I don't think they should or have to, Commissioner. I think the Commission, this Commission and other commissions that I have seen operate, have the ability to protect customers from adverse consequences of activities within the corporate umbrella.

Q. Well, that would be then our action, but I guess in theory if the rate payers get the benefit, I mean in theory shouldn't the rate payers assume that risk as well?

A. I don't think they necessarily have to assume the risk. I think they ought to recognize or the Commission in setting rates ought to recognize that equity in terms of calculating the weighted average cost of capital, as is being done here. So I think the fact that the corporation has a 40% equity ratio is something that is properly considered in setting rates even though you could go through an allocation and derive a result that the utility has less than 40% equity. And that's why it's my opinion that the claim of cross-subsidy is incorrect, because I think the utility customers get the benefit of the equity, and I think it is appropriate that utility customers pay the recognition of that equity when their capital costs are built in to their revenue requirement.

Q. And if the performance of the affiliates then by your testimony reflects negatively upon the corporate issuances of the company, then that should not be -- that should not be imputed to the utility and the rate payers then?

A. No, I don't think it should be imputed. I think there should be protections, and I think there are protections. I don't think in this circumstance the downside results of the unregulated activities are reflected in the revenue requirement for the customer, so I think there is a protection built in to the way the regulation is administered.

Q. That's all on that line of questioning.

The other, just very quickly, one of the criticisms at least that I have heard of the single stage DCF, I'm not sure if it's a method or methodology, I guess single stage would be the method?

A. Yes, sir.

Q. The single stage method of determining the long-term, you know, performance of a particular equity issuances, is that it's very difficult and perhaps it's to accept the fact that in the single stage analysis or single stage method that you have to assume a growth rate, a growth in the rate of dividend payouts in perpetuity. Now if I understand the method correctly, also that the, you know, the multistage DCF methods at least tend to try to mitigate the impact of imputing in perpetuity a growth in dividend payouts. And so I guess my question to you is, if my understanding is correct, then why did you select the single stage DCF model as your preferred model and not the multistage models, which tend to correct for the, as you have noted, a very simple way of performing DCF, which is looking just at those particular factors and including then having to impute a long-term or in-perpetuity growth in the dividend payout?

A. Well, I think there are many attractive things about the multistage, and it has been pointed out I presented a multistage model here in 1999. I can take some modest credit for taking the multistage model and selling it to the Federal Energy Regulatory Commission before that. But the problem with the multistage model is it presumes you know what investors expect over the horizon. And as the Commission pointed out in 1999, it's really hard to define that over the horizon growth rate. We have very rich information, because security analysts get paid big money, because investors want to know what security analysts see for the next five years, which is about as far as any security analyst is comfortable projecting. So for the multistage model you have to move beyond the specific forecast of security analyst to a more generic approach like the growth in GDP as the Federal Energy Regulatory Commission uses it for gas pipeline cases. But even that, we know that those long-term forecasts have a great deal of error, and we are not sure if that's really what investors are considering when they buy the stock. Now one thing that has come to me --

Q. Excuse me, Dr. Avera, but before you go that far, well, is there more error than in the multistage method than there is in the single stage where we know that there -- that dividends are not going to grow in perpetuity? I mean that's certainly the -- I think the -- one of the failures or one of the weaknesses, let's put it that way, of the single stage DCF method. So is that error -- apparently you believe that that error is less, presents less risk in the final analysis than the error that you're describing in the multistage analysis?

A. Well, I think whether it presents less risk or not depends on the facts and circumstances. I think in the '90's we had a situation where investors believed there was a transition where the utility industry was moving from a regulated industry to a competitive industry. And because they believed that, I think it was reasonable to suppose that their over the horizon growth rate was a general GDP growth rate when utilities would be just like any other company in the economy and on balance would realize the same growth as people expect the economy to grow.

As we have moved into 2005, I think that belief about the transition is over. I don't think investors are thinking that we're moving to a fully deregulated utility industry. I think they're thinking that we are going to continue under some form of regulation, maybe a different form at the wholesale level from the federal government than we have at the retail level from the individual state commissions. So I don't think it's as easy now to model those future growth rates as it was in the mid to late '90's.

In terms of the error though, one of the points is it's not the theory, it's what investors really think. It's how investors go about their business of deciding are they going to spend $18 of their dollars to buy this piece of paper that represents future dividends and future earnings. And to the extent that investors are only looking at and are weighting heavily the next five years that they can see and don't weigh those out years, I think that's the best way to replicate investor expectation. Because one of the things about the out years is not only are they hard to forecast, from a present value basis they don't matter. Because as you apply higher, you know, your 1 plus K to the end term becomes bigger and bigger. Those future cash flows in terms of present value contribute less and less to the discounted cash flow value of the stock. So I think just looking at the forecast that we have for five years and assuming those will go into perpetuity, we really doesn't do a whole lot of violence to the way investors are presently making decisions.

COMMISSIONER OSHIE: Thank you very much.

JUDGE CAILLE: Anything further for this

witness?

Thank you very much, Dr. Avera, you are excused.

THE WITNESS: Thank you, Judge.

JUDGE CAILLE: And, Mr. Gorman, if you will please take the stand.

(Witness Michael Gorman was sworn.)

JUDGE CAILLE: Thank you.

Ms. Davison.

MS. DAVISON: Thank you, Your Honor.

Whereupon,

MICHAEL GORMAN,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MS. DAVISON:

Q. Would you please state your name for the record, please.

A. My name is Michael Gorman.

Q. And by whom are you employed?

A. Brubaker & Associates.

Q. Are you the same Michael Gorman who has submitted prefiled direct and rebuttal testimony in this case?

A. I am.

Q. Do you have any changes or corrections to your testimony?

A. I do. In my direct testimony, Exhibit 331 --

JUDGE CAILLE: Mr. Gorman, would you hold on just a moment, please.

Okay, I believe we're ready here.

A. Okay, let me correct, it's actually a schedule attached to my direct testimony, Schedule 334, which is listed as Exhibit MPG-4, on line 16 under column 2 --

JUDGE CAILLE: Excuse me just a moment, that is Exhibit 334 for the record.

A. On line 16 under column 2, the bond rating Baa1 should be struck and the bond rating Baa3 should be inserted, and those are -- that completes my corrections.

Q. If I were to ask you the same questions today, would your answers be the same today?

A. Yes.

MS. DAVISON: Your Honor, I would like to move the admission of Exhibits 331 through 347.

JUDGE CAILLE: Is there any objection to the admission of Exhibits 331 through 347?

Hearing none, those are admitted.

And I believe Mr. Meyer --

MR. MEYER: Yes, given the ground that's been covered already through our witness, Dr. Avera, we have no cross, we're prepared to waive cross.

JUDGE CAILLE: All right.

Commission Staff?

MR. TRAUTMAN: We have none.

JUDGE CAILLE: All right.

Commissioners, do you have any questions of Mr. Gorman?

Well, then, thank you, Mr. Gorman, you're excused I guess, thank you very much.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Gorman, just very briefly I wanted to ask you about your comparable group that you used in your analysis. And, you know, it, when I read your testimony, it struck me that you had used for the electric utility essentially a group that was comprised of electric utilities, and Avista is of course comprised of two sides of the house, electric and natural gas. And so my question is very general, it's why you selected as for your group of comparable utilities electric utilities only, or perhaps it's just the way you have labeled them, that they do have a natural gas business as well.

A. Well, I selected a group which I thought reasonably proxied the total investment risk of Avista. Avista's largest utility segment is electric. They do have a gas also. But the problem in selecting companies which perfectly match investment characteristics is that it's simply not possible in today's marketplace. The publicly traded companies that are followed by the Value Line investment surveys which are predominantly electric utilities also have other businesses that exhibit greater risk than do regulated operations. Generally speaking, regulated operations are widely perceived by the marketplace as being very low risk, highly predictable operations. And gas utilities in particular have a variety of different mechanisms, regulatory mechanisms, and affiliates which go into providing not only the pipe service and sales gas service but also many downline activities for the benefit of large customers and other business elements. So for those reasons, I felt that the companies that were followed by the Value Line investment survey characterized generally as electric utility companies provide adequate proxies for total risk for Avista, recognizing it has both electric and gas operations.

Q. I would like to ask you, and thank you for your answer, the same question really that I asked Dr. Avera as to, you know, the differentiating between the single stage DCF model and the multistage model and whether you have a similar belief as he does that single stage while simpler presents less risk than the multistage model for determining long-term expectations of investors?

A. I agree with Dr. Avera that the objective of a DCF model is to try to capture the expectations of investors, and it's reasonable to believe that investors make rational investment decisions. So with that as the foundation, in selecting whether or not a constant growth model or multistage model is appropriate, one could reasonably look at the investment fundamentals of the industry and the companies in particular.

Currently the constant growth model is a superior model to the multigrowth DCF model, and the reason that is is because the financial metrics of the underlying industry and the companies in particular support the mathematical assumptions made for the constant growth model. In a constant growth model, it's believed that dividends and earnings and book value will all grow at a constant rate into perpetuity. What has to happen for that to achieve? Well, the earnings --

the percent of dividends paid out as earnings has to be a reasonable target level for the utility. That is the payout ratio can't be abnormally high, can't be abnormally low, it has to be about where one would expect the utility industry to be. Consequently the payout ratio is poor at a constant growth and utility dividends and earnings throughout time.

A second parameter is whether or not the dividend itself is too expensive or too cheap and consequently would cause the utility to pay out a greater or smaller percentage of its earnings as dividends. Currently you dividend the book ratios, that is the cost of the dividend to the utility is right around 6% to 7% depending on the utility you look at. With authorized returns on equity dropping down to the 10% area and lower now, utilities can afford to pay that dividend, retain enough earnings in order to grow their dividends into the future. So from a fundamental standpoint, today's low capital market costs have been reflected fundamentally by the utilities and the expense they're willing to undertake in payment of dividends to shareholders. So that's a second reason why the constant growth model is fundamentally sound today where it might not have been in prior periods.

And that I would like to expand on just a little bit, because in prior periods those assumptions didn't hold. In the early 1990's, the dividend payout ratio in the industry was around 90%. That payout ratio had to come down because the utilities simply couldn't retain enough earnings to grow with the dividends in the future. It was paying out too high a percentage of earnings as dividends. The dividend to book ratio was around 10% or 11% when their authorized return was around 11% or 12%. There wasn't enough spread between authorized returns and costs of dividends to allow adequate retention of earnings to fund future growth. By retaining earnings, you invest in additional utility plant, which creates additional operating income, which goes down to the bottom line in the greater standing of which funds -- greater earnings, which allows the utility to increase their dividend going forward. So fundamentally ten years ago the multistage model had some appeal because the mathematics of the utilities' financial metrics simply didn't support the constant growth assumption. That's not the case today.

Q. I want to follow up very briefly on the testimony that's given by Dr. Avera and just to, you know, actually get your opinion, because it was a little bit different, at least I understood his testimony to be a bit different than his written testimony in that the, and I'm getting back to the, just to be clear, the capital structure and imputing the 40% capital structure to the utility where that equity does not exist at this present time. And just to summarize, and you have been sitting here all morning and you have heard him say that because of the positive impact that the affiliates have on the corporate structure as a whole, either from earnings that have been distributed to the parent and it's the impact upon the outlook of the company as a result, and also the diversity of the or the diversity of having multiple lines of business as well as the utility, those benefits inure to the rate payer, and as a result that the capital structure of the corporate parent should be used in determining rates at least for this proceeding. So that's his testimony in very general terms as I understand it. I understand from your testimony you have a different opinion, I would just like to see if your opinion has changed as a result of hearing his testimony, his cross-examination testimony this morning?

A. It has not changed. My opinion is, and as I understand it the regulatory model is, that the utility's rates should be set on their costs they incur to provide utility service. The cost of making equity investments in unregulated affiliates is not a cost of providing utility service, so it simply shouldn't be in the rate making calculus.

Q. As the corporate parent is the issuer of the debt, isn't that the, and I don't -- how does the -- how would we -- how if we wanted to let's put it, maybe change this question a bit, if we were to exclude certain costs that are resulting from the parent's activities for the benefit of the rate payer, and let's use as an example the issuance of new debt, if the debt is rated on a corporate level, how would we go about doing that at the utility level?

A. It would be extremely difficult. I mean you can look at the utility's embedded debt structure and get a sense of just how much that corporate bond rating debt, how much more that costs than the debt that is mortgaged by utility property. There's a dramatic difference in that cost today. So in direct response to Dr. Avera that these non-regulated companies are benefiting regulated operations, that completely contradicts the clear evidence that the subordinate debt of the utility costs significantly more than the forced mortgage debt of the utility, far more than one would reasonably expect if you look at the utility without the non-regulated investment risk that this company has, the differential. So there is no real benefit in the debt cost calculations, and I strongly disagree with him that there's any benefit at all to the equity investments in non-regulated companies in terms of ensuring the utility's ability to attract capital.

COMMISSIONER OSHIE: All right, thank you very much.

JUDGE CAILLE: Anything further?

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Just one question on the equity building mechanism that you listed in your rebuttal testimony, I just want to understand your description and your support or lack thereof for an equity building mechanism. Are you opposed in principle to an equity building mechanism, or are you opposed to this specific equity building mechanism in the joint, in the settlement agreement?

A. Well, I'm responding to the settlement agreement as a whole, and the objective of the settlement agreement as I understand is to increase customers' rates in a way that provides the utility adequate cash flow to pay down debt and increase its common equity ratio. The problem with the settlement is that there's no commitment on the part of the company to actually fulfill its obligation to increase its common equity ratio and in part compensate rate payers for having paid rates in what I believe to be higher than this utility's cost of service. There is no commitment to not increase the dividend during the period the settlement rates are in effect. It is entirely possible that the company could use this rate increase to fund increases to dividends, which is in direct contradiction to the objective of reducing debt.

Now as part of that overall position, one argument I made is that the equity building mechanism doesn't provide any assurance, doesn't provide adequate assurance to customers that if they are required to pay more than this company's cost of service and the company doesn't fulfill its obligation to strengthen its balance sheet and improve its credit rating during this settlement period that there would be penalties imposed on the company that would discourage them not fulfilling their obligation under the settlement. The equity building mechanism is tied to equity targets, not to commitments. And to the extent they don't achieve those targets, there's prospective rate changes several years down the road. But the increase in rates the company gets in the interim is all theirs, the additional revenue is all theirs.

Q. So you would regard the penalty mechanism, a overall rate decease of 1% in I think '07 and '08 --

A. Yeah, April of '07 and potentially a second one in April '08.

Q. I mean there are two ways that you can motivate parties or a party to do something. One is with incentives, and one is with penalties. So what you are proposing is that the settlement agreement specifically provide both, to keep the penalty in there but provide an incentive as well and to firm up the language so what, the dividends increase, cash flow could not be used to increase dividends?

A. There would be a commitment by the company not to increase dividends, to use all additional cash flows produced in this rate order to pay down debt.

Q. Have you ever seen an equity building mechanism in any commission around the country that does that?

A. There are forms of it in other jurisdictions. In Wisconsin as a state public utility holding company, and as part of that their regulatory commission looks at the financial capital structure of the utility, which includes non-regulated activities if they're inside a utility, and a regulatory capital structure. They set common equity targets for Wisconsin Utilities, and if the utility does not achieve those targets, then they limit the amount of dividends the utility can pay up to its parent company. Now the utility doesn't pay public dividends, they pay dividends up to a parent company. Yeah, there is, that is one example of a commission being involved in a regulatory overview of the utility's dividend payments.

COMMISSIONER JONES: Thank you, that's all I have.

JUDGE CAILLE: Anything further?

All right, now, Mr. Gorman, you are excused, thank you.

Let's call Mr. Malquist to the stand.

MR. MEYER: During the lunch hour we're going to gather up some additional, we're having sent to us some additional documentation he was going to rely on in light of some of the matters that were deferred to him, but we can go ahead and get him on the stand and mark the exhibits and make the best use of this time.

JUDGE CAILLE: All right, let's do that.

(Witness Malyn K. Malquist was sworn.)

JUDGE CAILLE: Thank you.

Mr. Meyer.

MR. MEYER: Thank you.

Whereupon,

MALYN K. MALQUIST,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Malquist, have you prefiled direct testimony in this proceeding?

A. Yes, I have.

Q. And do you have any changes or corrections to make to that?

A. No, I do not.

Q. Are you also sponsoring what has been marked for identification as Exhibit Number 32?

A. Yes, I am.

Q. Any corrections to that?

A. No.

Q. If I were to ask you the questions that appear in your Exhibit 31, which is your prefiled direct, would your answers be the same?

A. Yes, they would.

MR. MEYER: Thank you.

With that, I move for the admission of Exhibits 31 and 32.

JUDGE CAILLE: Is there any objection to the admission of Exhibits 31 and 32?

Hearing none, they are admitted.

CHAIRMAN SIDRAN: Mr. Meyer, we have ten minutes, can you do something productive with the ten minutes, or we could take it off the back end and start at 1:15 instead of 1:30.

MR. MEYER: Why don't we just proceed to cross. There may be an item or two that Mr. Malquist would like to defer until he has that additional documentation, but I would like to make the best use of the time as well, so I will look to the witness to say that he's at a point at which he would like to have that additional documentation, so proceed to cross?

JUDGE CAILLE: Yes.

MR. MEYER: Would that be your preference?

CHAIRMAN SIDRAN: Yes.

JUDGE CAILLE: Mr. ffitch.

MR. FFITCH: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good morning, just barely, Mr. Malquist.

A. Hi, Mr. ffitch.

Q. You were probably starting to think that you might be escaping to lunch.

A. I'm happy to be here.

Q. My cross, I think we'll be able to get you off to lunch reasonably timely. We have, if I could just ask you to turn to your Cross Exhibit 33, and just bear with me a moment while I locate my notes which seem to have -- oh, here we go. That's a response to Public Counsel Data Request 704. I see you're still locating it there.

A. I have it, yes.

Q. Okay. And in this request we asked Avista to provide a copy of the most recent bond rating agency reports for Avista Corporation, correct?

A. Yes.

Q. And then what's attached are the various reports that you provided us, right?

A. That's correct.

Q. And if we go to page 1 of the first report, that's a Fitch ratings report, right? They have misspelled the name, but that is a Fitch rating report, correct?

A. Yes, it is.

Q. And this is the -- these generally are the most recent bond rating reports, right?

A. They were at the time that we responded to the data request. I think there's a later S&P report

that's out.
     Q.   Okay. Now on the first page or second page of the exhibit here there's a paragraph or a section with a heading rating rationale, and if you could go down to the third paragraph of that section, and I just want to ask you to read the first sentence of the third paragraph, begins the relatively high.
     A.   Sure.
           The relatively high business risk exposure associated with Avista Energy, Inc., AE, Avist's wholly owned resource management and energy trading and marketing subsidiary, is a source of concern for investors, particularly given its meaningful projected contribution to consolidated cash flows.
     Q.   All right, thank you. Now can you point to any place in your testimony or in the proposed settlement where you have explicitly segregated out the effect of the high risk energy trading and marketing subsidiary in computing either the capital structure or the required return on equity for Avista in this proceeding?
     A.   No, I haven't done that, because if you look at all of the comments on this page, I think the next

sentence is very directly impacted:

A regionally focused resource management and trading strategy with a relatively short term book mitigates the concern.

And so throughout I think all three rating agency presentations, they acknowledge this as a risk, not an insignificant risk, but they also say we have done as much as we can to mitigate the concern such that it is one of many factors that impact the bond rating.

Q. That's mitigate, not eliminate, correct, Mr. Malquist?

A. Yes, that is true.

Q. Now can I get you to turn to page 5, actually just page 2 of the exhibit, and that at the top of the page contains a diagram of the corporate structure of the company, correct, or of the consolidated company?

A. Yes, that's correct.

Q. And we can see Avista Energy for example down in the lower left quadrant.

A. Yes.

Q. Correct?

A. Yes.

Q. And that's overall an accurate depiction of the corporate structure?

A. Yes, it is.

Q. Now can you turn to page 5, please.
A. Sure.
Q. And can you look at the second full paragraph on the left-hand side, please, and just read the last sentence there which states that Fitch expects minimal new capital commitments.
A. I think I'm not with you, page 5?
Q. Page 5 of the exhibit.
JUDGE CAILLE: Is this page 5 at the top, Mr. ffitch, or --
MR. FFITCH: It is page 5 at the top.
JUDGE CAILLE: Thank you.
THE WITNESS: Thank you, Your Honor, that was my confusion.
A. I have it, now where would you like me to look?
BY MR. FFITCH:
Q. Left-hand side, the second full paragraph, and then if you could just read us that last sentence please, Fitch expects.
A. Is that the one that starts with while AE?
Q. Fitch expects minimal new capital commitments, this is in the second full paragraph on the left-hand side.
A. Oh, thank you, I'm with you now.

Fitch expects minimal new capital
commitments to AC's operations over the
coming five years and would view future
meaningful commitments to its
non-utility operations as a negative
credit development.

Q. Is Avista planning any meaningful commitments to its non-utility operations over the coming five years?

A. No. In fact, we have been taking capital out of the other businesses and providing it to the utility.

Q. Now can you turn to page 9 of the exhibit, please, and that's the exhibit pagination, this is part of the Standard & Poor's report, I think the second.

A. I have it.

Q. You know, actually just to sort of lead us into this if I can have you back up to page 8 on the front page of the report.

A. Yes, I have it.

Q. And can you just read us the first sentence of the second paragraph, the ratings on Avista Corporation.

A. Sure.

The ratings on Avista Corp. reflect the
consolidated credit profile of the

company's utility business, its energy
trading subsidiary Avista Energy, and
other small non-regulated subsidiaries.

Q. Okay, now let's go over to where I went first, page 9 at the top, and if we go to the 4th line down, there's a sentence that starts, the scale of operations.

A. Mm-hm.

Q. At Avista Energy, can you just read that section which goes on to end with the risk profile stand-alone utility a few lines down.

A. Okay.

Q. Just read that, if you wouldn't mind, please.

A. (Reading.)

The scale of operations at Avista Energy
has tapered off since the Western U.S.
energy crisis as its strategy shifted
toward marketing activities focused on
physical assets. Nonetheless, continued
involvement in riskier energy trading
and marketing activities contributes to
a weaker consolidated business risk
profile than the stand-alone utility.

Q. Okay. Now I think I touched on this a moment earlier, but can you describe how you have disaggregated the riskier energy trading and marketing activities from the stand-alone utility in computing the capital structure for the affiliate in this proceeding?

A. Again the answer is I have not, because I have not felt that it's necessary to do that. The next sentence I think is critical as part of what Standard & Poor's is saying here:

> The concern is partly mitigated by conservative risk management policies, adequate liquidity, and a consistent historical financial performance.

Q. Okay, not eliminated?

A. Not eliminated, certainly considered, one of many factors.

Q. And you're asserting that the equity ratio you're defending in this case is based on a projected consolidated capital structure, right?

A. The equity ratio that I'm defending in this case at this point is a stipulated settlement of 40%. It was a part of a number of trade offs that we made with the parties that settled.

Q. All right. I was referring in my question to the initial filing of the company.

A. Oh, sorry, thank you, that is correct.

Q. I guess my last question, Mr. Malquist, is how can a reasonable person interpret this as anything other than utility rate payers supporting the riskier parts of the corporation through the use of this consolidated rather than the stand-alone capital structure?

A. Well, Mr. ffitch, I would suggest to you that the customers have actually benefited, the utility has actually benefited over the last several years as a result of having the unregulated operations of the company. Avista Energy has paid $185 Million including $15 Million this year up to Avista Corp. that have been used to try to keep the equity ratio higher than it otherwise would be at the utility the way you all are looking at it. That really the low equity ratio is a result of difficulty the last four or five years through the energy crisis, and so I don't see this as in any way a subsidy. In fact, just the opposite, I believe that we haven't had full cost recovery the last several years from our customers, and our shareholders have been subsidizing.

Q. So your testimony is that during this era since 2000 when the company has had at least two rate cases and requests for interim rate relief and significant increases in residential rates, that that constitutes consumer benefit through this kind of a capital approach?

A. The difficulty that we have faced with significant increases in fuel and purchase power costs, below normal hydro conditions, et cetera, et cetera, have prevented us from earning our authorized return on equity. Had we earned our authorized return on equity and did we not have significant deferral balances still outstanding, our utility equity ratio would be above 40%.

MR. FFITCH: Those are all the questions I have, Your Honor.

JUDGE CAILLE: Did you have some cross?

MS. DAVISON: Yes.

JUDGE CAILLE: All right, go ahead.

MS. DAVISON: Thank you, Your Honor. I wanted to start off by asking questions on 34C, which is marked confidential. I can -- my questions are general in nature.

JUDGE CAILLE: Why don't we take our recess now.

MS. DAVISON: Okay.

JUDGE CAILLE: And come back at 1:30.

MS. DAVISON: Okay.

(Luncheon recess taken at 12:00 p.m.)

A F T E R N O O N   S E S S I O N

(1:30 p.m.)

JUDGE CAILLE: Good afternoon, we are reconvened after our luncheon recess, and I believe was it Mr. Van Cleve, are you going to cross --

MR. VAN CLEVE: Yes, Your Honor.

JUDGE CAILLE: -- Mr. Malquist?

MR. VAN CLEVE: Yes.

JUDGE CAILLE: All right.

MR. VAN CLEVE: One thing first, Your Honor, I would like to move for the admission of Exhibit 35 or what's marked as Exhibit 35, which is the form 10-Q dated August 5th that has now been distributed to the parties.

JUDGE CAILLE: Is there any objection to the admission of this exhibit?

MR. MEYER: No objection.

JUDGE CAILLE: Then Exhibit 35 is admitted into the record.

And you may proceed, Mr. Van Cleve.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Mr. Malquist, I would like you to refer to Exhibit 34C.

A. I have that.

Q. And I would like to try to ask you some questions about this exhibit which has been designated confidential without getting into any confidential information. And is this an exhibit or is this a document that's prepared on a monthly basis?

A. Yes, sir, it is.

Q. And what is the general purpose of this document?

A. It's really to allow us to manage the company effectively by understanding the pluses and minuses as the year goes on on a monthly basis compared to budget, how we're doing compared to our budget for the year. Allows us to the extent that we start to see significant variances, particularly if they're of a negative effect, to take some action to try to offset variances from our budget.

Q. And this document was, it says on the first or on the second page that it was published on September 29, 2005?

A. Yes, that's correct.

Q. And it reflects data through what date?

A. This is data for the month of August 2005 and for the year to date through the end of August 2005 as well as it also shows data, actual data for annually for

2002, 2003, and 2004.

Q. Okay. If you turn to the next page, and which at the bottom of the sheet it says 5.

A. I have that.

Q. Are there some other pages of this document that weren't provided?

A. I'm assuming that there are other pages in the interim, but my memory doesn't bring those to mind what those could be. They could be of a graphical nature, they could be pictures to depict actions that our crews have done during that time. I just don't know, I don't recall.

Q. Okay. On this page denoted as 5 if you look at line 12.

A. Yes, I see that.

Q. That line provides under the year to date column the actual earnings per share compared to the budget; is that right?

A. That is correct.

Q. And then further over it has the budget for 2005, and it compares those to the actual earnings per share for 2004, 2003, and 2002; is that correct?

A. That is correct.

Q. All right. If you could turn four more pages back to a chart labeled gross margin variance.

A. I see that.

Q. And you see the top portion of the chart where it says power supply components allowed in the deferral mechanism?

A. Yes, I do.

Q. And then the next portion of the chart refers to gross margin components not allowed in the deferral mechanism.

A. I see that.

Q. And why do you separate those out?

A. I think the purpose here is to calculate the impacts that are going to flow through the ERM in the state of Washington. And the second item, second set of items as it says are gross margin components not allowed in deferral mechanisms, either Idaho or Washington.

Q. Does the company consider whether a cost will be subject to a deferral mechanism when it's making a business decision?

A. No, we try very hard to make the best decision that we can for our customers whether or not that will flow through the ERM or not. In fact, you know, Coyote, which I think you have talked about a bit, I think is a good example of that where we currently are operating Coyote with significant benefits flowing through the ERM without cost recovery of that plant.

Q. If you could turn back to what has page 11 at the bottom, I think it's two more pages back, it's a graph.

A. I have that.

Q. And what does this graph depict?

A. These are the electric deferral balances starting in January of 2001 on an actual basis running through August of 2005 and then projected based on, the projected deferral balances based on the current estimate of fuel and purchase power costs.

MR. VAN CLEVE: Okay, that's all the questions I have.

JUDGE CAILLE: Any redirect?

MR. MEYER: Yes, I do, Your Honor.

R E D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Malquist, you were asked a series of questions by Mr. ffitch relating to the impact of Avista Energy and the company's business risk profile; do you have further comment?

A. I do. I would just -- I would like -- I guess I would like to point out that I think that the rating agencies and the financial community take into account what's happening with non-regulated subsidiaries. And, in fact, I found it interesting as I reviewed Mr. Gorman and Mr. Hill's testimony that the comparable groups that they used essentially were roughly a business position 6, which indicates comparable risk to our business position 6, and yet there was some interesting factors that came out of that. I'm looking now at Exhibit 334.

Q. Excuse me, can you just give me a moment to look for that.

A. For Mr. Gorman.

Q. Okay.

MR. FFITCH: Your Honor, I haven't objected here because it appeared that while the question was very, very open ended, simply inviting a general narrative statement from the witness, the answer appeared to be directed immediately to my cross. I just want to raise a concern here that the witness not now engage in a lengthy tour through various exhibits and a long speech about a whole range of topics that weren't specifically addressed in my cross-examination.

JUDGE CAILLE: So is that a soft objection?

MR. FFITCH: It's a soft objection, Your Honor.

JUDGE CAILLE: And the basis of your objection is?

MR. FFITCH: Well, Mr. Meyer didn't ask any specific question about my cross, he simply invited the witness to comment on the issues raised by my cross. The witness has commented, and now the witness is beginning to start apparently walking us through exhibits. And if it's going to continue in that vein, I would interpose an objection that the witness is just being asked to give sort of a free flowing narrative not responsive to any particular question.

JUDGE CAILLE: All right, I assume you will object if it continues.

THE WITNESS: So I will try to keep my answer short then.

JUDGE CAILLE: Yes, please.

A. The point that I wanted to make from this exhibit as well as a similar one in Mr. Hill's is that the parties have suggested that there is risk associated with Avista Energy, which I absolutely agree. The rating agencies take that into account, as does the investment community. In the comparable groups we see a number of utilities with similar business positions as us, and that suggests to me that we have done a good job of mitigating the risk associated with Avista Energy since we're placed in essentially the same comparable group as these other utilities are.

In addition, I would point out that the common equity ratio for that group is in the 43% to 47% range where we're talking about 40%. And the bottom line for me, what I found interesting here was that if we indeed were being reflected with a 30% utility ratio, our debt rating would be lower than this, we would be financing at a higher cost than we can currently finance. We recently did 5.45, it would be higher were we not able to essentially take into account the equity component that is at Avista Energy and our other subsidiaries.

BY MR. MEYER:

Q. Mr. Malquist, you were also directed by Public Counsel to some rating agency presentations. Do you have any further elaboration with regard to more recent discussions you have had?

A. Well, we do meet with the rating agencies on a regular basis two to three times a year. We in fact had a discussion with the rating agencies just last week in New York. We visited the agencies and discussed -- we always talk about Avista Energy because it is an important part of the risk profile of the company. I guess I would highlight just two things from the conversation.

We talked specifically about Avista Energy, and I asked Fitch at the end of the, that's F-I-T-C-H, at the end of the meetings, I asked Phil Smith and Rob Hornick, if we didn't have Avista Energy, would you upgrade us. And the answer was no. They said that our financial metrics are not good enough at this point to warrant an upgrade. And I have had similar discussions with the other rating agencies, and so I believe we're getting benefit from Avista Energy, that it's not a detriment to us, and it actually has I think helped us significantly with the dividends that we have been able to pay from that particular business.

We also talked about the equity building mechanism, and I try to see that as -- I'm trying to see that, the carrot in that, Commissioner Jones, rather than the stick from your earlier discussion with Mr. Avera I believe. And the carrot that I see is we do need to build our equity ratio, there's absolutely no doubt in my mind, and I want to be able to do that. The difficulty in doing that, if we have dividend restrictions, if we don't have -- if we have to allocate some of the rate increase toward building down the deferral mechanisms, I think -- I actually think that that makes it more difficult for us to issue equity in the marketplace, because it will have a detrimental impact on our stock price.

MR. MEYER: That completes my redirect, thank you.

JUDGE CAILLE: Commissioners, any questions of this witness?

MR. VAN CLEVE: Your Honor, I just had one follow up on the exhibit that you referred to, Mr. Gorman's.

JUDGE CAILLE: Go ahead.

R E C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. That's Exhibit 334.

A. Yes, sir.

Q. I note on that exhibit that Puget Sound Energy has a business profile rating of 4; is that right?

A. Yes.

Q. And they have a common equity ratio of 39% to 40%?

A. They do.

Q. And Puget is also subject to hydro risk?

A. They are.

Q. And do you know what the business profile rating of PacifiCorp is?

A. I don't, no, I don't.

Q. Would you accept subject to check that it's 5?

A. I would.

MR. VAN CLEVE: Okay, thank you.

JUDGE CAILLE: And is that all for this witness?

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Just two questions. One is I think in your prefiled direct, Mr. Malquist, you indicated that you have decided as a matter of policy to use free cash flow to pay down debt where possible over the past two, three years and not issue stock, common equity if you will.

A. That's correct, Commissioner.

Q. What is the basis for that decision?

A. Well, as we have looked ahead the last -- I can go back to 2002 and 2003 and 2004, and each year as we have looked ahead --

Q. Let's just do 2004.

A. Okay, 2004 as we looked ahead to 2005, we always project normal weather and the current energy prices that are in effect, and we have projected that we would bring down the deferral balances between $30 and $40 Million a year. That's actually a pretty significant amount of equity build that can be had without having to issue any new stock. And so we have been planning to build the equity ratio back up to where it was pre-energy crisis, but our uncooperative weather and hydro conditions have simply not allowed us to get to where we had hoped to be. So we are -- we're actually in discussions at the present time with companies to begin a continuous equity offering program so that we can put some equity into the marketplace. You will see a financing application associated with that as well as associated with some other means of raising equity in the next couple of months. I absolutely believe we should be raising equity ratio.

Q. On page 3 of your prefiled direct testimony, you talk about the goal for your credit rating, and I just want to confirm that that is still your present goal, which is triple B or weak A, is that still the present goal of the company?

A. Yes, sir, it is.

Q. And has anything in this rate proceeding changed your view of that goal?

A. No.

Q. Of the company?

A. No, it hasn't changed that view.

Q. And is it your view that if -- that the settlement agreement will provide the basis for Wall Street analysts to upgrade the corporate credit rating to this level?

A. I believe that it will get us there, perhaps not next year, but I'm hopeful that in 2007 that we can get there.

COMMISSIONER JONES: Thank you.

JUDGE CAILLE: And for the record, the Mr. Malquist direct testimony is Exhibit Number 31.

Anything more for this witness?

All right, you're excused, thank you, Mr. Malquist.

And we are now going to take a witness out of order, our next witness will be Mr. Cloward.

(Witness Randall O. Cloward was sworn.)

JUDGE CAILLE: Mr. Meyer.

Whereupon,

RANDALL O. CLOWARD,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Cloward, for the record please state your name and your employer.

A. Randy Cloward, Randall O. Cloward, with Avista Corporation.
Q. And have you prepared rebuttal testimony that has been marked for identification as Exhibit 221?
A. Yes, I have.
Q. Any changes to make to that?
A. No, there are none.
Q. So if I were to ask you the questions that appear in that prefiled testimony, would your answers be the same?
A. They would.
MR. MEYER: With that, Your Honor, I move for the admission of Exhibit 221.
JUDGE CAILLE: Any objection to admission of Exhibit 221?
Hearing none, then it is admitted.
And, Mr. ffitch, you have cross-examination for Mr. Cloward.
MR. FFITCH: I do, Your Honor. Public Counsel agreed to the company's request to take Mr. Cloward out of order to accommodate his schedule, and one of the issues for us is whether to direct certain questions to Mr. Falkner or Mr. Cloward. The original order had we thought served us pretty well, because we felt that Mr. Falkner could defer questions

to Mr. Cloward as necessary. Now with Mr. Cloward going first, we're hoping to make sure that we anticipate and ask everything we need to. So it may be that if in the event Mr. Falkner doesn't know the answer to some of his questions later on in the hearing, we might ask a record requisition or something of that nature just to be able to have Mr. Cloward fill in any missing points. So if there's a little bit of organizational issues with my cross here, that's why.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Good afternoon, Mr. Cloward.

A. Good afternoon, Mr. ffitch.

Q. Now you didn't file direct testimony in the case; is that correct?

A. That is correct.

Q. And you were brought in as a new witness by the company in response, to file rebuttal in response to transmission issues; is that correct?

A. Transmission issues, revenue issues for the most part.

Q. Okay. I just have a few questions for you. Let me ask you first to turn to your rebuttal exhibit, which is Exhibit 221.

A. Yes.

Q. And page 2, please.

A. Page 2, I have it.

Q. All right. And at line 10, beginning at line 10 there, you indicate that Mr. Lott's proposal in this case ignores the known changes that have occurred that have a direct impact on OASIS revenues. That's an acronym.

A. Yes.

Q. Open access same time information system, correct?

A. Correct.

Q. And that is your testimony, that you believe Mr. Lott ignores the known changes in that item, correct?

A. That is my testimony.

Q. Now can you just summarize what OASIS revenues are generally?

A. OASIS revenues are those revenues that we collect from third parties for the sale of transmission to others.

Q. All right. And you actually state that in your testimony on page 1 at line 21, beginning at line 21, don't you?

A. Yes, correct.

Q. Now going on to the lower half of page 2, there's a question that says, please explain, and in answer to that question you compare a number of years, you compare 2002-2003 to the 2001 total OASIS revenues of $6.9 Million, correct?

A. Correct.

Q. And you indicate that in 2001 these third party customers purchased almost all of Avista's excess power in order to give them flexibility even if they did not use it, correct?

A. That's correct.

Q. Was this a general situation in the Northwest where companies were buying up transmission in order to give themselves flexibility?

A. Yes, I believe it was. At the time, the energy prices were so high that the cost of transmission was very inexpensive, and for those people who knew that they needed the flexibility in the market, they purchased additional transmission.

Q. Okay. Now can I get you to turn to page 3, please.

A. Okay.

Q. At the top of page 3, line 3, you state that the company believes that 2001 was an anomaly and should not be used for future revenue forecasts, correct?

A. That's correct.

Q. And then if we go over to page 6, excuse me, same page, line 6, the next Q&A, you then explain some additional factors why you believe 2004 is an abnormal year, correct?

A. Yes.

Q. So my question is, did Mr. Lott include either 2001 or 2004 in his calculation of pro forma revenue?

A. To the best of my knowledge, he did not, he recognized them as anomalies as well.

Q. All right. Now I'm going to ask you to take a look at an exhibit that was marked for Mr. Falkner, and that's been marked as Exhibit 117, and that is response, an excerpt from a response to Public Counsel 217.

A. Okay, 117?

Q. Correct.

A. Okay.

Q. Now that data request is Public Counsel 217, and that asked the company for workpapers supporting the various adjustments included in the transmission adjustments including the OASIS revenue item, correct; is that right?

A. Yes, that's correct.

MR. FFITCH: Just give me a moment, please, Your Honor.

BY MR. FFITCH:

Q. And in the first response to this request, and we have had a number of responses to this particular request, haven't we?

A. Yes.

Q. Okay. In the first response, which I believe you have there in front of you, there's a confidential worksheet showing OASIS revenues on a monthly basis for five years ending December 31st, 2004, and this would be page 4 of the exhibit.

A. That's correct.

Q. Okay. And would you agree that the lowest annual year in the five year period for OASIS non-firm and short-term firm wheeling revenues was $3.1 Million in 2000?

A. I show $2.4 Million in 2000, page 4 of the exhibit.

Q. All right.

MR. FFITCH: I apologize, if I may just have a moment, Your Honor, just checking the sheet here.

JUDGE CAILLE: I just want to inquire whether we should be discussing these individual totals, because this is a confidential exhibit.

MR. MEYER: We're fine up to this point.
JUDGE CAILLE: All right, you will --
MR. MEYER: We will let you know if we cross the line.
JUDGE CAILLE: Thank you.
MR. FFITCH: I'm not able to pick up that line, Your Honor. I think what I'm going to do is move on to the next question, and we may just either address this with Mr. Falkner, or we can do it on the brief with these exhibits, I apologize.
BY MR. FFITCH:
Q. Referring you to page 6 now of Exhibit 221 again, your rebuttal.
A. Page 6, I have it.
Q. And on line 7 there in your testimony you discuss $816,000 adjustment, and this is related to line items that are labeled CASSO and OATI, can you just state what those acronyms stand for?
A. Yes CASSO is a control area services company where we and other members of the Northwest Power Pool pay for services to manage the control area. And OATI is the Open Access Technology International, they're a company in Minnesota that we use now for our OASIS web page.
Q. All right. And you're aware that on rebuttal

Mr. Lott dropped his removal of this adjustment based on workpapers supplied in response to his data request?

A. I am.

Q. Now can I get you to turn to page 7, please, and the question at the top of the page is discussing Colstrip operation, the Colstrip operation and maintenance adjustment, right?

A. Yes, for the transmission line.

Q. And the company called Northwestern provides the maintenance on this line, correct?

A. They do.

Q. And they bill Avista monthly for actual operating expenses and actual capital costs, correct?

A. Yes, they bill us monthly, and they provide a yearly budget.

Q. And the actual amounts vary from month to month, correct?

A. Correct.

Q. Your pro forma in this case is based on representations of Northwestern?

A. Yes, the budget that they provide.

Q. All right, the representations in the budget?

A. Yes. In addition, that budget has also increased for 2006 in a subsequent exhibit, I think it was 294, where the new budget amounts were even higher than the settled amount.

Q. Can you direct me to 294?

A. It was --

Q. Which witness is that for?

A. It was in response to Merton Lott, and I don't have another number. Oh, PC-217 Supplement 1.

Q. That's the new -- that's the cross exhibit identified for Mr. Lott?

MR. MEYER: That is correct.

A. It includes an E-mail and a brand new budget sheet from Northwestern Energy.

Q. All right, thank you.

Now in Avista's initial filing and workpapers, did Avista provide any evidence as to what the increase was for?

A. I believe the only thing that we turned in was the representation that Northwestern had given us for the 2000. No actually, I speak -- I spoke wrong. The budget for 2005 was not yet completed at the time, and that number was a forecasted number based on our 2004 actuals. We don't normally receive the information from Northwestern Energy in time for budget.

Q. Do you know and is there -- does the record state what the basis of the budgeted increase is, or is it simply a representation that this is the Northwestern budget for operations and maintenance?

A. It provides an itemization for each of the components that they plan to maintain for the transmission line. Is that what you wanted?

Q. Well, whatever your answer is, I'm just asking.

A. Well, the budget is fairly detailed, and it goes line by line.

Q. Was that provided in support of your original request for this adjustment?

A. It was not supplied until Exhibit 294.

Q. All right, which is a cross exhibit that was just identified on the eve of this hearing, right?

A. Yes.

Q. Now I'm going to go to a different area with some questions about Dry Gulch, and these had been -- I was going to direct these originally to Mr. Falkner, so if you want to defer to Mr. Falkner, you're in a great position to do that.

A. He reminded me of that, but if you're referring to Exhibit 118, I think I can take your questions.

Q. I am just going to try to make sure of that myself here. Exhibit 118 is another excerpt from the rather voluminous response to Public Counsel 217, is it not?

A. That's correct.

Q. Just to make sure we're looking at the same document here, this is -- the first page of the document is a landscape document with numbers, monthly numbers across the page and years down the page, and it's titled Avista Corporation PP&L Dry Gulch; is that correct?

A. I show it as 2 of the exhibit, but it's the first substantive page.

Q. I'm sorry, page 2 of the exhibit.

A. Okay, I have it.

Q. You're correct. The first sheet of this exhibit is, this is not marked confidential, all right, the first sheet of this exhibit is the company calculation of the $245,000 pro forma level shown in Mr. Falkner's workpapers?

A. That's correct.

Q. And when I say first sheet, I am referring to this page 2 in the exhibit. And in this case the company calculated a five year average of $221,827 and then escalated that amount by 5% for two years to arrive at the total shown of $244,561, correct?

A. That's correct.

Q. Now if I could ask you to turn to the next page, page 3 of the exhibit. Actually I think this one

is going to be page 4 of the exhibit, the DR sheet.
A. Yeah, I have it.
Q. And this is the sheet which shows the calculation of monthly demand at Dry Gulch for each month in 2002 and 2004 in megawatts, correct?
A. Yes, that's correct.
Q. And just for background by the way, can you just tell us what Dry Gulch is?
A. It's a substation where we provide some delivery of load to PP&L.
Q. Okay. In the line marked 12 month rolling ratchet, do you see that?
A. Yes.
Q. It's about two thirds of the way down the page on the left.
A. I see it.
Q. This is the demand applied to the bills on a monthly basis during 2004, correct?
A. Yes, that is correct.
Q. And those demands are the highest demand during the last 12 months?
A. Depending on how long that they were in existence. There could be a higher demand that follows the 25 for any given period year. It should be the highest in the previous 12 rolling from.

Q. Correct, that's --

A. I'm sorry.

Q. -- that is what I meant, the previous 12 months to the calculation here.

A. That's correct.

Q. This number shows the highest number during the previous 12 months.

A. Right.

Q. Correct?

A. That's correct.

Q. So when we look at January, the 25, January for example, the 25 megawatts is the level of demand back from July 2003, correct?

A. Correct.

Q. Now the monthly revenue is shown two lines later; isn't that right?

A. Yes, it is.

Q. And for January it shows $28,675?

A. Yes, and that number matches page 2 of the exhibit where it shows the 2004 actuals.

Q. Thank you. Total of the monthly revenues for 2004 is the $305,102, which Mr. Falkner shows in his workpaper; is that correct?

A. Subject to check, that's what that total is, yes.

Q. Okay, and that's the reference is PF1-5, that workpaper, I believe we have identified that as an exhibit in the case, so you can check that pretty easily.

Now if you refer back to page 2 of the, excuse me, page 2 of the exhibit, go to the bottom of the page, and the amounts shown for 2004 actuals start with the same $28,675, correct?

A. Correct.

Q. The worksheet does not show the total for 2004, but as shown on the second sheet we know that amount is $305,102, correct?

A. Correct.

Q. And it is correct that none of the last five years has revenue as low as the $221,827 shown as the five year average or the $199,196 shown as the three year average, do they?

A. Well, the $221,000 -- okay, that is correct, that is the lowest.

Q. Okay. Well, actually the question is, just to make sure you're agreeing with the right thing, the question is, none of the last five years has revenue as low as the $221,827 which is shown as the five year average; is that correct?

A. That is correct.

Q. And the same is true with regard to the $199,196 shown as the three year average?

A. Three year average, that's correct.

Q. In sheets 3 and 4 of this exhibit, which I believe are, make sure I'm giving the right reference here, well, the 2 pages we have just been looking at which is in this exhibit, sheets, pages, excuse me, this exhibit pages 2 and 4, they show a calculation based on the three years ended 2004, correct?

A. Correct, of $279,000.

Q. All right.

MR. FFITCH: Can I just check my notes, Your Honor, I may be finished.

THE WITNESS: Yes, that $279,000 was from Mr. Lott's average.

MR. FFITCH: All right.

THE WITNESS: Based on three years.

MR. FFITCH: Your Honor, the only item I had in the way of exhibits that we haven't addressed so far is we had -- I had raised this matter earlier before the hearing began, and that is that we have a additional portion of the response to Public Counsel 217 which is confidential, and we now have copies of that, and I simply -- I'm not sure whether we need to do that now or do that with Mr. Falkner. I don't have questions on it, I just mention it because it comes up right in connection with this particular series. But as I'm raising it, I think perhaps we can just deal with it administratively at the end of the day.

JUDGE CAILLE: That would be fine.

MR. FFITCH: I just wanted to flag that.

JUDGE CAILLE: I will put that on my list.

MR. FFITCH: I don't have any more questions, thank you.

Thank you, Mr. Cloward.

JUDGE CAILLE: Any redirect for Mr. Cloward?

MR. MEYER: Just briefly, Your Honor.

R E D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Back to the discussion of the OASIS revenues, I believe Mr. ffitch had asked you about calendar years 2001 and 2004; do you recall that exchange?

A. Yes, I do.

Q. And in terms of the other years in that historical string, 2002 and 2003, is it your belief that those are representative?

A. Yes, I do. And in addition we talked about the other average that Mr. Lott used to come up with a $3.4 Million, and I should add that the market conditions that we see going forward cause us to further adjust the number. It is only because we're privy to some market changes in the transmission world to know that that number might be slightly lower. And because that number is slightly lower, if we had not knowledge of that number being lower, we would have used Mr. Lott's method. Because it is a fine method, we just adjusted it for known conditions in the transmission marketplace.

Q. What has brought about those lower conditions or those changed conditions in the transmission marketplace?

A. Well, for the most part the new construction that has occurred as part of the trying to solve the West Hatway constrained issue in the Pacific Northwest, there's been additional construction by Bonneville for their 500 KV system, and that has significantly increased the available transmission capacity that they have. So that has affected our ability to sell transmission, because Bonneville has a larger footprint than ourselves. So if a company can get on Bonneville someplace, they can go further without having to pay any transmission rents to Avista. And so because they now have available transmission capacity, we think it is impacting the market conditions for us.

Q. And so do you expert our transmission revenues to correspondingly decline?

A. Yes.

Q. And finally, do you then believe that the settlement figure of $2.4 Million for OASIS revenues fairly captures what we could expect going forward?

A. Based on the numbers we have seen this year, it appears to be very accurate.

MR. MEYER: Thank you, that's all I have.

JUDGE CAILLE: Questions from Commissioners?

No questions, all right. Thank you, Mr. Cloward, you're excused.

Mr. Kalich, will you please take the stand.

MR. MEYER: And while he's doing that, Mr. ffitch, thank you for allowing an adjustment on your sequence of cross, that allowed Mr. Cloward to make other obligations, thank you.

(Witness Clint Kalich was sworn.)

JUDGE CAILLE: Thank you.

MR. FFITCH: Your Honor, with your permission, I have conferred with Mr. Van Cleve, and he has more cross than I do, and I would be happy to defer to him to go first and then see if he covers some of my areas.

JUDGE CAILLE: That will be fine.

Mr. Meyer.

MR. MEYER: Thank you.

Whereupon,

CLINT KALICH,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Kalich, for the record please state your name and your employer.

A. My name is Clint Kalich, and I work for Avista Corporation.

Q. And have you prefiled what has been marked as Exhibit 171 consisting of your direct testimony as well as 174 consisting of your rebuttal testimony?

A. Yes, I did.

Q. Any changes to make to either?

A. No.

Q. Are you also sponsoring what have been marked for identification as Exhibits 172 and 173?

A. Yes.

Q. Is the information contained therein true and correct?

A. It is.

MR. MEYER: Thank you.

With that I move the admission of Exhibits 171 through 174.

JUDGE CAILLE: Any objection to the admission of Exhibits 171 through 174?

Hearing none, they are admitted.

And Mr. Van Cleve.

MR. VAN CLEVE: Thank you, Your Honor.

JUDGE CAILLE: I see you have 90 minutes for Mr. Kalich.

MR. VAN CLEVE: Hopefully we can do it quicker than that.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Could you please refer to Exhibit 173, which is the exhibit to your direct testimony.

A. I'm there.

Q. And if you look at the third page of this exhibit.

A. Okay.

Q. Where it says total resource cost $82 Million for the annual number.

A. Yeah.

Q. What does that represent?

A. That represents the cost of running our resources, which here mainly are our hydro resources and our thermal resources, and what we're talking here really is about just the variable cost of fuel, well, exactly, it's fuel.

Q. So those are the costs that you're seeking to recover in this case?

A. That's a portion of the costs in the case, yes, but for these resources specifically this would represent the fuel for these projects.

Q. And is it your understanding that Mr. Falkenberg has proposed adjustments to this number that are approximately $14.3 Million?

A. I will need some more detail there, I'm sorry.

Q. Well, I'm asking if you would agree that Mr. Falkenberg has proposed adjustments to your numbers that total about $14.3 Million?

A. And could you reference where you're pulling those numbers from, please.

Q. Sure, I'm looking at Mr. Falkenberg's direct testimony at page 4.

CHAIRMAN SIDRAN: Counsel, can you give me an exhibit number, please.

MR. VAN CLEVE: It is --

JUDGE CAILLE: Direct testimony should be 301.

MR. VAN CLEVE: 301, yes, that's correct, Your Honor.

JUDGE CAILLE: And what's your page number again?

MR. VAN CLEVE: Page 4.

JUDGE CAILLE: Thank you.

MR. MEYER: Do you have a copy?

THE WITNESS: I don't have a copy of Mr. Falkner's testimony. Excuse me, did I say Falkner?

MR. MEYER: Falkenberg.

THE WITNESS: Falkenberg, I'm sorry, I have that information, I'm sorry. I'm reasonably familiar with his testimony believe it or not. I'm sorry, so we're on page probably page 3 or 4 here, I'm familiar with this yes, I'm sorry.

BY MR. VAN CLEVE:

Q. So you would agree that he's proposing about $14.3 Million worth of adjustments to your proposed Aurora numbers?

A. Yeah, thereabouts. I see a couple of the wheeling and the Kaiser that are modest relative to the rest of the adjustments, but I see the $14.3 Million.

Q. Now can you tell me what the comparable number to the $82 Million is for the settlement stipulation?

A. The comparable number that Mr. Falkenberg has proposed?

Q. No, that you're proposing.

A. That I'm proposing?

Q. In other words, I'm asking for the power cost that he calculated, the variable power cost, how the stipulation changed that number?

A. Could you repeat that question again, please, I'm sorry.

Q. Well, let me phrase it this way. What are the total variable power costs that are being proposed in the settlement?

A. The total variable costs, again if you're referring back to the third page of my Exhibit Number 173, those are just representing fuel costs, so variable costs actually are done outside of this, and Mr. Johnson picks up those costs.

Q. Okay, let's just talk about fuel costs then.

A. Okay.

Q. What's the comparable number for the settlement to that $82 Million?

A. The comparable number for the settlement, we have to go over to the settlement and through those adjustments in what I believe was Attachment A where there are some adjustments. You're referring here to for example the adjustment for Coyote Springs 2 fuel?

Q. Well, I guess what I'm asking is whether you recalculated the Aurora results to reflect the settlement adjustments?

A. Well, the answer to that's yes.

Q. Okay. So do you have an Aurora run that supports the settlement stipulation amount?

A. Okay, I think I see where you're going. To arrive at that, we didn't run an individual Aurora run. What we have managed to do or put together as part of the settlement were what I would define as incremental changes to the model similar to actually on Mr. Falkenberg did some -- did the analysis for Aurora. And so, for example, on one of the larger adjustments was the increase in gas price for the whole region and Coyote specifically, so you run an analysis that has all the assumptions exactly the same except you changed the gas price and run the model again, compare the two, and that provides you the incremental cost increase. In the case of fuel for example, the increase to 7.25 gas that we have referenced is about $3.6 Million Washington allocation.

Q. Could you refer to Exhibit 120.

A. I have it.

Q. This is a response to an ICNU data request that asks for detailed how the adjustments in Attachment A to the stipulation were calculated; is that right?

A. Yes.

Q. Okay. If you look on the second page of Exhibit 120 down at Paragraph C, can you explain the first bullet point there?

A. You're referring specifically to how it impacted the running of the Aurora power supply model?

Q. Right.

A. Yeah, the significant difference here was we proposed our case, we proposed using the entire hydro record from 1929 through 1988. Through the settlement, we agreed to use the 50 year period that ends 1978. So what we did was instead of calculating the 60 year average by averaging each of 60 years of water that we ran, we averaged the first 50 years, which coincided with the stipulation.

Q. So you calculated the 50 water years that were used in the stipulation in the exact same way that you did the 60 water years; did you run each of the years through Aurora?

A. We didn't need to. What you would do is the -- they're individually tracked as we run the model, they're stored in our database. So instead of summing up or averaging, excuse me, averaging all 60 years, you would just simply average the first 50 years.

Q. Now in the second bullet you talk about the NYMEX prices, and do you know what the dates of those 90 days of prices, what dates they were from?

A. Actually, yes, that was March, excuse me, May, June, and July of this year.

Q. Now would you agree that there's quite a bit of debate in this case about what the appropriate hydro years are used -- will be used to calculate --

Would you agree that there is considerable debate in this case about what hydro years to use in calculating normalized hydro supply costs?

A. Both the hydro period and also the matter -- it's not as simple as the years. Actually some parties have proposed a filtering approach. So in general there is disagreement as to which years of the hydro record are used to establish base rates, yes.

Q. And historically has Avista used a rolling 40 years average methodology?

A. For planning?

Q. For purposes of setting rates.

A. The most recent case we had in this jurisdiction we did not use the 40 year rolling average, no.

Q. If you can look at your direct testimony, Exhibit 171, at page 3.

A. Yes.

Q. I guess my question was based on your statement there that says that you did use the 40 year rolling average previously.

A. I was referring more historically back into the '80's and earlier as well. So if you want to look well back into history, we did use a 40 year rolling average as stated in my testimony. I was just referring to the most recent case in this jurisdiction.

Q. If you could refer to Exhibit 177.

A. Okay.

Q. Now this is a data response that shows the difference between what you propose in your direct case and the 40 year rolling average, right?

A. Yeah, I was asked to make that calculation for Public Counsel.

Q. And so using the 60 years increases power costs by about $8 Million?

A. Or the way it's represented here is going to 40 would reduce power supply expense by just about $80 Million, yes.

Q. Now have you calculated what the difference between the settlement methodology and the 40 year rolling average is?

A. I could do that math, I haven't calculated it.

Q. One thing that I'm trying to understand is what portion of the adjustment in Attachment A, the $3.651 Million adjustment for CS2 fuel, what portion is related to fuel and what portion is related to using the 50 years of hydro?

A. Yes, actually there's been some confusion there. The -- when the -- the analyst I have working for me put the numbers together, the intent of the company and obviously in the settlement was to include both those adjustments and that line item. And in reviewing the stipulation last night, I saw that text, and actually I went back as part of the preparation for this case in fact last night and looked at the spread sheets we put together to summarize the information, actually it was learned that the adjustment for Coyote for the higher gas price was exclusively that adjustment only. In other words, it did not include the 60 to 50 years change.

Q. Was the 60 to 50 year change included in Mr. Norwood's adjustments at page 5 of his rebuttal testimony?

JUDGE CAILLE: Could you please, so that would be Exhibit Number 12, or no, Exhibit Number 11.

THE WITNESS: I don't have a copy of that in front of me.

MR. VAN CLEVE: Exhibit Number 11, correct.

MR. MEYER: Just a moment.

JUDGE CAILLE: I'm sorry, did you give us a page number, Mr. Van Cleve?

MR. VAN CLEVE: Page 5 of Exhibit 11.

BY MR. VAN CLEVE:

Q.   Do you have page 5 in front of you?

A.   I'm sorry, yes, I do.

Q.   And I asked Mr. Norwood about this, I was just trying to understand the difference between his CS2 gas transportation adjustment and the one that's in the settlement stipulation.

A.   Based on my quick math, subject to check it appears that Mr. Norwood's adjustment does include the 60 to 50 years in the stipulation. If I'm referring to the right document, there's not an Exhibit A to the stipulation.

Q.   Okay, thank you.

A.   The magnitude of the dollars look about right.

Q.   So going from 60 to 50 is not a material difference in cost?

A. It is my recollection is about $274,000 system, $165,000 to Washington.

Q. Okay. If you could, I would like to ask you a few questions about the hydro filtering approach that Mr. Falkenberg is suggesting, and Mr. Falkenberg is proposing to remove all water years that are 1 standard deviation from the mean; is that correct?

A. That's my understanding, yes.

Q. And if you could refer to page 4 of your rebuttal testimony, which is Exhibit 174.

A. Okay.

Q. In this part of your testimony, you're basically taking the position that Mr. Falkenberg's suggestion should be rejected. Are you aware that he's proposing the same thing that the Staff proposed and the Commission accepted in the last PacifiCorp rate case?

A. I'm well aware of that. I'm also aware that the PacifiCorp rate case didn't -- the Commission was not privy to the information and the analysis performed by Dr. Dubin and Dr. Mariam, and that case actually settled as a fully litigated case in February of this year, but I am aware of that PacifiCorp settlement that included that methodology.

Q. You're referring to the Puget Sound Energy case, I believe that's --

A. Their 2004 case, the order was in February of this year.

Q. -- Docket Number UE-032043.

A. Actually that sounds like the PacifiCorp docket.

Q. I think it's the Puget docket. You're correct. 040641. Now would you agree in that case that the Commission stated that:

> We encourage the parties to continue their discussion of this subject and their efforts to develop even more rigorous tools for hydro normalization.

A. You're referring now to the Puget order Number 4 --

Q. Right.

A. -- of this year?

Q. Right.

A. Yes, there's language there.

Q. Have you reviewed the testimony from Mr. Buckley which was attached as an exhibit to Mr. Falkenberg's testimony that is Exhibit 303?

A. I did review it, yes.

Q. And you are in agreement that Mr. Buckley proposed the same methodology as Mr. Falkenberg is proposing in this case?

A. Yeah, I think they're generally if not the same.

Q. Is it your belief that Mr. Buckley's approach is unsound?

A. I believe that the work performed by two essentially Ph.D. econometricians is far superior and is more in line with the company's position over the years on this issue, and I think that we should be using recent precedent that as I just said is superior to that methodology.

Q. And did Dr. Dubin's work consider how deferred accounting might impact what hydro years should be used to normalize costs?

A. I can't speak to that.

Q. At page 3 of Exhibit 303, which is Mr. Buckley's testimony, he argues that the very real tendency of utilities to request rate relief in bad water years is one reason for his approach. And both Mr. Buckley and Mr. Falkenberg argue that it is inappropriate to include extreme hydro years in setting base rates if you also allow utilities to obtain deferred accounting in extreme years. Don't you think that's a valid concern?

A. I guess what I struggle with in that analogy, in fact as I read Mr. Falkenberg's testimony he sets up a world where there's no energy recovery mechanism in a world where, well, essentially rolling back the clock 20 years, and in that world there may well be a reason for the company to come forward in a poor hydro year. But with an energy recovery mechanism where costs are being reflected through -- already through the ERM, the hydro costs, I don't think there's any real certainty that the Commission would allow us to come into that circumstance. In fact, Mr. Falkenberg's analysis where he -- well, I will leave it at that.

Q. Well, you are aware, aren't you, that several utilities in this state have had energy cost recovery mechanisms in place over time but that none of them have been in place for a long period of time; is that correct?

A. I don't know the specifics. I could make a guess at PacifiCorp, or excuse me, Puget. I know we have had an energy recovery mechanism here since, what, 2001, 2002, and then obviously in Idaho since I believe 1989.

Q. And if you look at your rebuttal testimony, Exhibit 174 at page 7, there's a chart that shows the hydro deviation from normal over time; is that right?

A. Yes, that's what it represents annually.

Q. And what was the point in time when the energy recovery mechanism was put in place?
A. Shortly after, well, it would be the 2001 period there.
Q. So it was during some of the worst hydro conditions in the whole record since 1929; is that right?
A. Yeah, that's what the graph would show.
Q. And did the company also seek a deferral before the ERM was put into place?
A. For costs it had incurred up to that point when there was not an energy recovery mechanism in place, yes.
Q. But I think the point is that the utility generally controls the timing of when these recovery mechanisms are put in place.
A. I guess I don't see it that way. I saw prior to 2001 the company did not have an energy recovery mechanism that it could recover costs through, so there was a different need at that time. Going forward we have a different environment today where costs can be recovered through the energy recovery mechanism.
Q. Well, I think that's exactly the point if you look at the 97-98 time frame on your chart when hydro conditions were very good, the company didn't seek a

deferral then, did they?

A. Up until 2001 no matter whether the years were good or bad did the company ask for such a mechanism.

Q. And there was no ERM in place during the good hydro years, was there?

A. For neither the good nor the bad years preceding 2001.

Q. Now at page 4 of your rebuttal testimony, you state that excluding data violates statistical theory, and there's several other places where you rely on statistical theory for your argument. Can you tell us kind of what your background is in statistical theory?

A. I have a degree in economics, which included a number of courses in statistics. I have also been applying statistics since I started in the industry in 1991, first providing dualing load forecasting for electric utilities and then ultimately doing hydro casting. I have been working with hydro data sets since I began working with Tacoma Power in 1996.

Q. So you don't have any specific training in statistical analysis?

A. I don't think that's what I just said. No, I think I explained that I am -- I'm not a Ph.D. if that's where you're trying to go. I'm relying upon work of

Ph.D.'s in this exercise.

Q. Do you think that it contradicts statistical theory to exclude poor water years in situations where for policy reasons the Commission has decided that it will apply special rate making treatment such as deferrals to treat abnormal conditions?

A. No.

Q. Okay. I would like to refer you to page 6 of your rebuttal testimony, and here you argue that Mr. Falkenberg is cherry picking and that he wants to limit the data to the better water years or use the filtered water approach; is that right?

A. Could you please give me a line reference there? I mean I could read the whole page, but.

Q. Basically it's contained in lines 1 through 7.

A. Okay.

Q. Now wouldn't you agree that Mr. Falkenberg excluded both the good water years and the bad water years that were 1 standard deviation from the mean?

A. The concern was not whether or not he excluded both sides of the mean, working on both sides of the mean. The concern was he picked -- well, that's part of the concern. The other concern is he picked a hydro period that is historically above average, and you can see that actually if you would like to visit the next couple illustrations there, we can work through that.

Q. Well, I think what -- and your referring to your illustration number 2 on page 7?

A. 2 and 3, that's right.

Q. I think what Mr. Falkenberg said was that it didn't matter as much which water years you used if you excluded the water years that were more than 1 standard deviation from the mean; isn't that right?

A. To take Mr. Falkenberg to an extreme, I mean to the extent you take -- again, let's not forget this data has been shown to be trendless. Statistically normal -- when you have a normal distribution of data, data that is trendless, normally distributed, to pick and define 1 standard deviation as extreme is just an inappropriate interpretation of statistical theory. But just to step into that, if you think of a large data set and if you narrow the bands close enough to the average, well, you always end up with this average. It's granted you end up excluding highs and lows, and that would make sense if an average water, excuse me, if a low and a high water year were the same impact to a company. But in actuality, a bad water year hurts us a lot more than a good water year helps us. So by using this approach, we're using just a -- clearly not an extreme, just a filer of 1 standard deviation or a sigma as proposed by Mr. Falkenberg, you're eliminating essentially all the variability that's inherent in the data set, and you're not getting a true reflection of our power supply variability, and that's my concern with the way Mr. Falkenberg approaches, excuse me, approaches the problem.

Q. Now wouldn't you recover the extreme years that Mr. Falkenberg is excluding either plus or minus through the ERM?

A. Dr. Mariam in the Puget case explained that it is extremely important to consider all of the hydro years when you're dealing with an ERM, and I looked at some mathematics with the ERM in place. And, in fact, if you do the filtering approach as Mr. Falkenberg proposed, it actually creates a chronic undercollection problem. In other words, if you set the revenue requirement too low, which is essentially what's happening here, you have the deadband, which the company ends up picking up the deadband portion of that and then 10%, so what I would define as a chronic undercollection of costs. All costs aren't passed through to customers or to the company in this case. There's a middle ground where costs are shifted, and if you don't get the mean values right, you necessarily are going to bias the result.

Q. Now Mr. Buckley took issue with that conclusion, correct, if you look at page 4 of Exhibit 303?

A. Mr. Buckley sets up the hypothetical whereby the Commission will allow us as he calls it an insurance premium. They give us the ERM, and then we come back and get to double collect. Nowhere in the evidence Mr. Falkenberg, I mean he made this statement, but I don't believe that to be the case that the company would be afforded that opportunity. I don't think there would be a necessity to do that. For normal conditions in a bad hydro year, the energy recovery mechanism would pick up the variability there.

Q. But Mr. Buckley concluded that it would be appropriate to use the filtered water approach even where a power cost adjustment mechanism was in place; isn't that right?

A. He did come to that conclusion, yes.

And just to the point, Dr. Mariam came to the exact opposite conclusion, as have I.

Q. If you could look at page 10 of your rebuttal testimony at lines 5 to 15.

JUDGE CAILLE: And again, that's Exhibit 174.

MR. VAN CLEVE: That's correct, Your Honor.
BY MR. VAN CLEVE:
Q. Now in the 125 year study, wouldn't you agree that Mr. Falkenberg included the very best hydro periods from the 1890's as well as the very worst which occurred from 1929 to 1938?
A. And you're referring here again to his filtered approach when he looked at this data; is that correct?
Q. Yes.
A. Which gets back to my other point, if you essentially eliminate the variability and the expense, you come up with a mean value. But if -- you're basically taking all the results out that the -- get to the gist of the issue, which is trying to quantify how much variability is inherent in our power supply.
Q. Well, I think that the point that Mr. Falkenberg was getting at is that the period 1929 to 1938 reflected some, and if you look back at your chart on page 7 of Exhibit 174, that that reflected some of the worst hydro conditions in the last 250 years if you go back and look at some of these projections in these studies that Mr. Falkenberg cites. So his point I think, wouldn't you agree, is that if you're going to include those years that you should use the filtering

approach, but if you're not going to use the filtering approach, then you need to include all available years, the 125 year study?

A. He attempts to make that point, yes.

Q. Okay. I would like to ask you a few questions about the hydro shaping adjustment, and I think that is your testimony starting at page 12.

A. Of my direct?

Q. No, that's of your rebuttal Exhibit 174, and I just -- this is a question about how you modeled the output or spread the output of the hydro resources in Aurora, and can you tell us first how Aurora dispatches the thermal resources?

A. The thermal resources?

Q. Yes.

A. After Aurora has completed the dispatch of the hydro system, it steps back and dispatches the thermal resources, and it does so by looking at the essentially the margin between the cost of running the plant and the market price at that time in that hour.

Q. So then --

A. And then if --

Q. So is that what they refer to as economic dispatch?

A. For a thermal plant, yeah, that's how it's done.

Q. And it's dispatched to a trading curve; is that right?

A. It's dispatched, yes, to a market price.

Q. Now are hydro resources modeled differently?

A. They are, yes.

Q. Can you explain how the -- what that's based on?

A. In the Northwest we have a whole lot of hydro. Avista is 50% hydro, which is about twice as -- we're twice as energy dependent on hydro as Puget is and four times as dependent as PacifiCorp, so it's important to get this right. But just stepping back for a minute on how industry standard models work, they essentially shape the load. In other words, they do peak shaving. So your goal with your hydro plants is to reduce your obligation to swing your other resources. So you will, for example, if you have a morning and an evening peak, you will tend to run your hydro plants in the morning and the evening. In Aurora this is emulated in Aurora by going through and taking a look at the peakiness of the resources, accounting for the operational reserve requirements, all these different things. In fact, I can go through in my testimony, talk a little bit more in detail about reasons that we can't necessarily run a maximum/minimum every hour. But within the constraints that are set up on each hydro resource, the model will then essentially what we call peak shave and slice off those peaks and then from there, like I explained before, then we go into the hydro, excuse me, the thermal dispatch.

Q. What is, in this case, what is the Aurora dispatched hydro based on?

A. Well, we're probably going to have to bifurcate this. One is for the market at whole, the total market, so we're talking about the 30,000 megawatts of hydro up in the Northwest, and that is essentially done to shave peaks. That is the algorithm, it goes through and shaves peaks.

Q. Well, is it correct that you modeled the hydro using historical dispatch records?

A. Yes, one of -- with any model you have to make certain simplifications, and with Aurora what happens is for each load area, and there's actually one for Oregon, Washington, Northern Idaho as an example, and actually three quarters of hydro, the high -- excuse me, 50% of the hydro electric base is in that area. About 75% of Western interconnect hydro capability is in the Northwest, which is a little bit bigger than that, BC, Alberta, Southern Idaho, and Western Montana. But for OWI, Oregon, Washington, Northern Idaho, try not to use the acronym if I can help it, there's essentially it's modeled as one large hydro electric plan.

And EPIS, the vendor of Aurora, goes through and looks at historical data, and they hire people. For example, they have an individual who came from a power planning council who has had a lot of experience doing hydro modeling. And they create a, I hate to use the word generic, but that's really kind of what it is. It's essentially if we had one super hydro unit to provide all the hydro electricity in the Northwest, and in the case of that unit there's a lot of run at river plants in the Northwest, and our system has more capability shifting energy to the peak hours to reduce customer costs than the average hydro electric resources are in the region.

So were we not to use the hydro shaping factors to push more of our hydro energy into the peak hours, we would be dispatching our plants like the rest of the plants in the Northwest and not adequately reducing our customers' costs. So that's why we had to bifurcate and move -- and actually model our resources separately to ensure we got enough energy into the valuable peaking hours.

Q. I guess my question was, did you use

historical records for the dispatch of the Avista hydro resources?

A. Yes, for the Avista hydro resources we used, as it states in my testimony, a five year average.

Q. And I think the criticism that Mr. Falkenberg makes of that is that the operators actually dispatch with the knowledge of what the market conditions are, not based on what the five year average is; isn't that right?

A. That's Mr. Falkenberg's assertion. Unfortunately I think he's mistaken in his understanding of that issue.

Q. So the operators actually do dispatch the hydro resources based on the five year average?

A. No, and what my testimony explains is the 5 year average is extremely similar to a 1 year average, a 10 year average, or a 15 year average. Our loads still -- the weather seems to be reasonably similar year to year, if you look at historical load and generation patterns you get very distinguished shapes. When you look at -- when you're teaching a new analyst what a load shape looks like, and many of us have probably seen some simplified examples, you know, you have probably seen examples where the double hump, you got the morning and the evening peak, and in our service territory in the summers you have really one extended peak that goes over time. Well, those -- they're simplistic representations, but they're a representation of reality, because that's really how the system operates year to year independent necessarily of the specific load you're serving, which I think one could argue that our load is fairly similar year to year. But the point here I'm trying to make is the load shape year to year is very similar on our system, and that's what my testimony explains.

Q. And do the dispatchers consider market prices when they dispatch the hydro, the Avista hydro resources?

A. Probably the clearest way to get the answer you're looking for is our hydro operators maximize the value of the hydro turbines within the limitations of the hydro electric system.

Q. So if there is discretionary energy, they could shape it to periods when market prices are higher?

A. And they do, yes.

Q. And they do. And looking at a five year historical average does not necessarily capture that; is that correct?

A. No, that's not correct. I -- it would -- again, as I mentioned earlier, any model requires some simplification. You can't get everything right in a model no matter how large it is. If you go back and look at the 5 year average, 68.1% of our energy was generated, by our hydro resources, was generated on peak. The 10 year average was 67.9% I think, and 15 year average was 67.7%. The 5 year average actually manages to shove 68.4% of our hydro electric energy into the on peak hours. So, you know, going back to is the model behaving reasonably and representing our system accurately, I think that's an excellent way to make that measurement.

Q. Now the adjustment that Mr. Falkenberg made was based on the output of just the Clark Fork hydro resources; is that right?

A. That's my understanding, yes.

Q. And at page 18 of your rebuttal testimony, Exhibit 174.

A. Yes.

Q. Well, let me ask you first whether you understand that Mr. Falkenberg used the maximum hourly hydro generation from the inputs that Avista prepared for the Clark Fork, which are a 5 year average of monthly maximum loadings.

A. He used, yeah, he based -- essentially in his analysis, his spreadsheet analysis, is he looked at the maximum and the minimum for every month that came out of Aurora and used that to set his dispatch.

Q. So he used the same maximum as you did?

A. Yes.

Q. And if you look at your chart, illustration number 6 on page 18, it shows that he never dispatches the Clark Fork resource at more than 460 megawatts; is that right?

A. Yeah, the maximum generation level on that chart is 400, well, subject to check, 460, looks like that on the chart.

Q. And Clark Fork that you're referring to here includes the both Clark Fork and Noxon Rapids; is that right?

A. Noxon, the upstream storage project, and Cabinet Gorge, the downriver, downstream project, yes.

Q. And if you look at your chart on the next page, page 19, that shows the name plate capacity of those facilities at 778 megawatts; is that right?

A. That's probably the least important thing on that chart, but 778 is referenced.

Q. And would you also agree that what's depicted in this chart were all bad water years?

A. All but 2002 would be, yeah, an average or a below average hydro year. Yeah, 2002 was the one year that was modestly above average or average. 2001 is the big outlier in there.

Q. And do you have Exhibit 306, which was the exhibit to Mr. Falkenberg's testimony that had the hydro data Aurora results?

A. Yes, I have it before me.

Q. And if you look at page 3 of Exhibit 306, the years 2000, 2004, those are the years that are depicted in your chart, correct?

A. Those are two of the years that are, yeah, I guess if you're looking for a comparison.

Q. And I guess what I'm comparing it to are the ten years that occurred before that that the hydro generation is, in many years, is substantially higher than the 456 megawatt limit that Mr. Falkenberg used in his analysis?

A. I think my understanding is you're comparing capacity to energy here; am I interpreting your question correctly?

Q. I think I'm comparing capacity to capacity.

A. Okay, you'll have to help me, rephrase the question.

Q. Well, I guess I am comparing capacity to energy, you're correct. And basically the point is that in good water years that the -- that those plants can operate significantly higher than what -- at a significantly higher level than what Mr. Falkenberg assumed.

A. It appears to me that this chart, you're referring to a column of data that includes all of our projects added together, not just for the Clark Fork.

Q. Okay, just a couple more questions.

JUDGE CAILLE: Mr. Van Cleve, are you going to a new area, because this would be an appropriate time for us to break if you are.

MR. VAN CLEVE: Yes, I am.

JUDGE CAILLE: All right, why don't we take a 15 minute break, we will be back at 3:15.

(Recess taken.)

JUDGE CAILLE: We're back from our mid afternoon recess, and we are taking care of an outstanding exhibit.

MR. FFITCH: Your Honor, this is yet another excerpt from the response to Public Counsel 217. It is confidential, and it does relate to OASIS revenues. I would propose that we add it to the cross exhibits for Mr. Falkner.

JUDGE CAILLE: So that would be Exhibit 122 under Falkner.

MR. FFITCH: Thank you, Your Honor, and I can provide 8 copies for the Bench.

JUDGE CAILLE: Please.

MR. FFITCH: And distribute it at this time.

JUDGE CAILLE: Yes.

122C, may I ask if there is any objection to the admission of this exhibit?

MR. MEYER: None.

JUDGE CAILLE: All right, then 122C is admitted.

MR. FFITCH: Thank you, Your Honor.

JUDGE CAILLE: And, Mr. Van Cleve, I believe you were in the process of your cross-examination.

MR. VAN CLEVE: Thank you, Your Honor.

BY MR. VAN CLEVE:

Q. I would like to ask you, Mr. Kalich, about the issue with the Colstrip upgrade, and if you can look at Exhibit 178C.

MR. MEYER: Excuse me, what exhibit number?

MR. VAN CLEVE: 178C.

MR. MEYER: Thank you.

A. Okay.

BY MR. VAN CLEVE:

Q. This data response talks about a proposed upgrade to Colstrip in 2006; is that correct?

A. Actually we're talking about two upgrades, one that would happen potentially in mid '06, the second one happening mid '07. There's been reference in this proceeding to 50 megawatts of capacity, I just wanted to make it clear we're talking about a little under 4 megawatts of increased capability for each unit of Avista's share for the 15% ownership of that 50 megawatts.

Q. And you would agree that that update or the upgrade in 2006 is expected to occur during the test year?

A. I don't know that I can say that. The analysis that's included in this exhibit presumes that that would occur. In other words, oftentimes when you do an economic analysis, you would do an evaluation and see if you would want to move forward with a project, so you will put a maybe an estimated time in there when it might occur, and I think that's what -- I assume you're referring to the spreadsheets.

Q. Right. If you look at the first spreadsheet at the bottom it has date of 10-28-2004.

A. Yes.

Q. And can you tell us what progress has been made on implementing these upgrades since then?

A. I can tell you that to my knowledge there has not been -- trigger hasn't been pulled if that's the right phraseology. The analysis that was done back in October of last year was preliminary work based on some initial work that the -- again we're a 15% owner, so we don't really have controlling interest of these projects, and we kind of follow the crowd. Follow the crowd isn't the right word, but we certainly are participants, so we had some preliminary information. And then based upon that preliminary information, I was asked to review the economics to see if we thought it might be a good idea to proceed forward with these upgrades.

Q. And what did you conclude?

A. That the upgrades based upon the costs provided in the preliminary estimates from the vendors looked attractive.

Q. And do you think personally in your opinion that the upgrade will be completed in 2006?

A. I can't say that it will be.

Q. Have you been given a budget for the upgrade?

A. I have not. The only numbers, again the analysis here was based on some preliminary information, detailed work discussion with vendors, so there's no budget, no finalized numbers that I'm aware of.

Q. And are you the person who's responsible for following this project?

A. No, I'm not, we have an engineer assigned to that task.

Q. And have you asked him whether there's any new information about when the upgrade is going to be completed?

A. I have not been made aware of any new information.

Q. And would you agree that in calculating his adjustment for the upgrade that Mr. Falkenberg did include the capital costs?

A. You're asking me back to his direct testimony on table, what was that, on page 4?

Q. Right.

A. His summary of the recommended adjustments included both the value of the upgrade as well as the putting capital under rate base?

Q. Yes.

A. Is that what --

JUDGE CAILLE: We're referring to Exhibit Number 301 on page 4.

A. That's what his table does illustrate. But I haven't confirmed the numbers specifically here. I mean I can -- I guess they look reasonable based on the numbers in that exhibit we just looked at previously.

Q. Okay. I would like to ask you about the

Colstrip maintenance adjustment. Could you look at page 21 of your rebuttal testimony.

A. Did you have a line there?

JUDGE CAILLE: Mr. Van Cleve, could you help us with the exhibit number.

MR. VAN CLEVE: Sure, Exhibit 174.

JUDGE CAILLE: Thank you. And the page again is?

MR. VAN CLEVE: 21.

BY MR. VAN CLEVE:

Q. Isn't it correct that Mr. Falkenberg found a problem in the way the Colstrip maintenance was modeled in your original case?

A. Mr. Falkenberg did some mathematics based on a historical period and came to a different, a modestly different result regarding the historical maintenance periods at Colstrip.

Q. Well, wasn't the -- didn't the original model run have the maintenance occurring across all hours of the year?

A. Oh, I'm sorry, that was in my direct testimony.

Q. Right.

A. Yes, the company identified during the, and I don't remember the specifics of how it went, but certainly once that issue was identified, the company moved to change the maintenance periods. It was unreasonable to have maintenance occur around the year, which I think is what you're getting at that Mr. Falkenberg pointed out in his testimony.

Q. Right. And so the debate now between you and Mr. Falkenberg is about what are the right assumptions for when that maintenance will occur, right?

A. Yes.

Q. And it makes a difference when the maintenance occurs because that low cost coal resource has to be replaced with market purchases, and market purchases vary by month; is that right?

A. I guess I will answer yes.

Q. And generally do the operators of Colstrip try to schedule the planned maintenance in the months when it will be least costly to the owners?

A. Probably need to provide some more illustration here on how the maintenance actually is planned. If you look in actually one of our exhibits, and you may well take me to that exhibit, you will see for 2005 and 2006, excuse me, 2006 and 2007 Avista has within its position report planned maintenance to occur in essentially April, May, and June, with most of that I think occurring in April, or excuse me, May and June. I mentioned earlier we're a 15% owner. We don't control the maintenance schedule.

In actuality at this point there is no maintenance schedule for the plant. I think any operator of a coal plant may well want to perform that maintenance in April, or excuse me, in May and June, but the reality is that circumstance don't allow it whether it's obtaining labor to do that maintenance, whether it's obtaining materials, or whether it's the fact that the plant has some poor performance issue. In fact, I think specifically in 2003 we had to pull a unit out in March because we had some major failures there.

So it's not as simple as looking at when we have a plan in our position report, you have to put it somewhere in your position report, and if you look historically at our position reports, we had hoped to do the maintenance in May and June, in actuality it turned out we did maintenance in March, in April, May, June, and in July.

Q. So you assume in your testimony at page 21 of Exhibit 174 at line 12, you assume that 10% of the maintenance occurs in March, right?

A. Yes.

Q. And that's generally a more expensive month, power prices are higher than say April or May; is that right?

A. Yeah, March is probably -- it would be March and then April. March would be expensive, April would be a little less expensive, you know, May is a little less and June is less. I mean there is a shape, and if you look at my direct, we could look at a table in my direct where it actually provides the monthly pricings, but I think you're -- I think March.

Q. You were referring to Exhibit 176C, and this is the planned maintenance schedule for Colstrip?

A. This includes both historical and plant.

Q. And is there any planned maintenance that occurs in the month of March?

A. In 2003 it looks like we had 10 days in March of maintenance. We have essentially the full month of April out in 2004.

Q. So there's no -- I'm not sure I can ask this question without -- is this all confidential information? Can you --

A. This being the page here?

Q. Yeah.

A. Yeah, it's marked as such.

Q. Okay, I will leave it at that.

One final area I wanted to ask you about was the bidding factor adjustment that you made to the

Aurora results. And first I would like to refer you to your rebuttal testimony, Exhibit 174, at page 2, and if you could look at lines 29 through 33, could you just read that into the record for us?

A. Sure.

Q. 29 through 33.

A. (Reading.)

Bidding factors are designed to align forward natural gas and electricity prices so that they reflect current relationships between the two commodity prices. Absent bidding factors and a correct representation of the relationship of natural gas and electricity, company resources are not dispatched in a proper manner. The company's power supply expenses therefore would not be properly calculated absent bidding factors.

Q. And can you explain how this adjustment is actually done?

A. Yeah, Mr. McIntosh yesterday provided a pretty good illustration, but essentially what is happening with bidding factors -- but let me just pause for the intent. The intent as it says here is to ensure that relationships are reasonable between natural gas and electricity. Natural gas is an input into the Aurora model, and natural gas along with the other fuels and the loads in the model actually determine then what resources run and then ultimately what the market clearing price is in every hour that's modeled. So what we found when we ran the initial run is there were four months of significant concern in that two of them exceeded a 20% difference and two exceeded 15% relative to the relationship in the forward prices for natural gas and electricity. In other words, well, I will leave it at that, but -- and then if you look at the historical period, they also were out of alignment with the historical period going back, and I have an illustration in my rebuttal testimony on that. So with that in mind, the idea here is to go in and help the model to do a better job of estimating what the price of electricity is relative to natural gas, because we have, you know, 500 megawatts of gas plant, so we need to make sure that we determine what the margin or the value of those generating assets are based upon reasonable estimates of the market price.

So to do that, getting specifically to your question, Aurora adds what they call a bidding factor, and it's a feature that Aurora has had for many years, and it's used by many companies to help emulate forward market prices. One of the reasons that the -- one of the -- the time it was very popular was during the energy crisis when there were a lot of things happening in the marketplace in real time that maybe people couldn't fully understand fundamentally. So in any given hour, the dispatch price is decremented or incremented depending on which way the alignment is going to essentially affect the dispatch price of the marginal unit in the WUCC.

Q. So Aurora is a fundamentals model, correct?

A. It is, yes.

Q. And it produces a forecast of the market price?

A. The forward, yeah, electricity price, that's true.

Q. Of the electricity price?

A. Uh-huh.

Q. And that's based on it has data for all the resources in the Western system, correct?

A. Yes.

Q. And what you're doing with the bidding factors is you're comparing the Aurora price to the forward electric price to see how they match up?

A. That was the exercise that I did, that's

true.
Q. Okay. Now for the settlement, you updated the forward gas prices, and you changed the hydro data; is that right?
A. No, as I explained earlier, what -- all 60 years are run, all I did was simply instead of taking the average of the 60 years we ran, I went back and averaged the 50 years that we had run. So it's the same dataset of the same database, you just don't query any of the data past 1978.
Q. Okay. But on the gas price you did update the gas price?
A. Oh, I'm sorry, yes, we did.
Q. And did you update the bidding factors?
A. We did not need to do that.
Q. So I think you testified earlier that the forward gas price used in the settlement was from NYMEX prices from May, June, and July; is that right?
A. The updated prices, yes, were from those three months, the average.
Q. Okay. Now what forward price curves did you use for the bidding factors?
A. You know, really we're talking about -- it's immaterial to the case first of all, and I can back up. When the prices were done, it was back on our original

filed case, so the prices went up I think it was December through February. So the forward curve -- let's keep in mind what the model is trying to do. It's trying to align the fundamentals of the marketplace. Once you've aligned the fundamentals, there's not necessarily a huge difference in how -- the same resources are dispatching to serve load, you just have a higher price of gas. Gas is in larger 95% plus correlation between gas and electricity now, so you really aren't changing the dispatch of resources in the model, you're just updating the marginal fuel cost. So really again the bidding factors are more to adjust the fundamentals of the model. Just because you move the fuel price around really doesn't have any significant or material effect on the result, so the company didn't therefore need to update those.

Q. The company didn't need to, it doesn't create any kind of mismatch to have a gas price from May, June, and July and bidding factors from many months earlier?

A. No, the results are --

Q. That's --

A. It gets --

Q. Go ahead.

A. It gets back to, as I explained earlier, once you have cleaned the fundamentals up, the model -- the same resources dispatch in hour X as they did when gas prices were $1 and some odd cents less. The same resource dispatches, it just has a different gas price.

Q. What if the spark spread between gas and electric has changed during that time frame, wouldn't that mean that you do need to update the bidding factors?

A. Oh, I think if the spark spread changed materially you could see some significant things get out of kilter, but the spark spread did not move significantly in that period of time. All that happened was gas -- I mentioned the high correlation, gas and electric are about 95% correlated, everything just went up, both gas and electricity, so the relationships were very similar.

Q. One final question I forgot to ask you about the Colstrip maintenance. On the adjustment that's on Attachment 1 to the stipulation, did you rerun the Aurora model to determine that adjustment? In other words, when you changed from the averaging maintenance across the whole year to the specific months that you picked out.

A. I'm sorry, so did I run Aurora?

Q. Right.

A. I did not, no.

MR. VAN CLEVE: Thank you, that's all I have.
JUDGE CAILLE: Mr. ffitch.
MR. FFITCH: Thank you, Your Honor.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:
Q. Good afternoon Mr. Kalich.
A. Good afternoon.
Q. I would like to first of all go back to hydro normalization. You were asked by Mr. Van Cleve about the dollar impact of different methodologies for hydro normalization; do you recall that?
A. Might you be referring to that Data Request 151 maybe it was?
Q. Well, what I'm remembering is that he asked you for the dollar impact of the settlement methodology, 50 years methodology versus I believe he was asking you for the difference between that and the ICNU recommendation in terms of dollars, and there was a discussion about $8 Million I think at that point.
A. Yeah, my recollection is it was looking at the 40 year period of record versus the 50 year period of record, excuse me, versus the 60 year period and you have $7.9X Million.
Q. Well, let's pursue that a little bit. Can I

ask you to turn to, and I don't know if you have a copy of this, but Exhibit 287, which is the rebuttal testimony of Merton Lott.

A. Actually, I do.

Q. Page 14.

A. Did you say page 14?

Q. Page 14, there is a table.

A. Yes.

Q. On that page. You see that Table 1 entitled Alternative Hydro Normalization Results?

A. Yes.

Q. And I assume you have taken a look at that as you were reviewing Mr. Lott's testimony?

A. I did.

Q. And what Mr. Lott does there is that he attempts to lay out the cost impact of the different methodologies that have been discussed in this case, correct?

A. That's my understanding.

Q. And he gives a source for each of the different calculations in this table. And if we look at the top of the table, we see that this is -- this represents the 60 year cumulative average approach unfiltered, which is the company's recommendation in its initial filing, is that right, that's the methodology?

A. Yes.

Q. And the impact, cost impact adoption of that methodology is $90.54 Million; isn't that right?

A. Yes.

Q. If we go down to the next line, we see that this is the methodology from the settlement, a 50 year cumulative average, and that's an unfiltered approach, that is the settlement methodology, correct?

A. Yes.

Q. And the difference there is in the range of $300,000 or less than $300,000 between that cost impact and the original company proposal, doing math on the fly?

A. Well, what I'm comparing it to is the number I remember was $274,000, which is modestly different from these figures, but I understand where you're taking me here.

Q. All right.

A. So it's modestly, it's in the range that you're referring to.

Q. All right. And as we move down further, the 40 year rolling average unfiltered, that figure is approximately $3 Million lower in impact than the company's original proposal, correct?

A. Yes.

Q. And a little less than $3 Million below the settlement. That methodology is the 40 year rolling average methodology that you had referred to in discussions with Mr. Van Cleve as the methodology that was in use for quite a period of time by this Commission and by companies before this Commission, correct?

A. It's a little different. I think it's worth pointing out that this data goes through 2004. I'm not aware that the Commission has used anything besides data that's gone through the Power Pool.

Q. That's correct.

A. But I understand that the way the math, the algebra or the math was done is essentially, yeah, the rolling, last rolling 40.

Q. It's the last rolling 40 in this case, you're correct, that's a useful clarification, that it does use the most recent data up through 2004. But other than that, just conceptually as a 40 year time period unfiltered, the most recent 40 year time period, that's consistent with the I guess I will use the term the traditional or the historic approach that you mentioned of the 40 year rolling average?

A. Yeah, and again I just wanted to point out that about 24, about half, more than half of that record has not gone through any normalization for reservoir constraints, irrigation depletion, all of the non-linear relationships that are inherent in the hydro symptoms. So it's essentially looking at streamflow data versus actually going back and doing the work that the Power Pool and the Bonneville Power Administration do to what I would term normalize the data.

Q. All right. And that comment that you just made relates to the specific 40 year time period that is covered by this line item.

A. That's true, yes.

Q. Okay, and I'm just getting -- asking you to other than that, separate from that issue, this is the historically employed 40 year rolling average approach?

A. Yes.

Q. Okay. And I understand that there is some debate about whether, now getting to the point that you're making, there is some debate about whether to wait for the sort of perfect conditioning or evaluation of those streamflow numbers before you make any kind of hydro calculation, isn't there?

A. Yeah, I think there's -- there are many of us in the industry that would like to see this data be updated more recently. It's just a rather huge endeavor to do, so yes.

Q. The most recent data available with the kind

of workup that you're referring to is 1978, correct?
A. Actually, it's 19 -- well, you know, the nuances here, there is a break in methodology at 19 -- well, actually not, and what we filed for the Power Pool data, actually the assumptions are the same all the way through the 60 year data set through 1988.
Q. So we have to go back at least until 1988 before you have these kinds of numbers that are, you know, the perfect or quality numbers with the curves developed, correct?
A. Yes.
Q. But you do -- but there is streamflow data available right up through 2004, correct?
A. That's true.
Q. Well, if we go down to the next line, this is simply a representation of the impact of using all the data since 1879 without any kind of statistical filtration, correct, based on Mr. Falkenberg's numbers?
A. Yes.
Q. His exhibits?
A. Yes.
Q. And that's about $5 Million less than the settlement level and the Avista level?
A. Yes.
Q. Now you had indicated that Mr., excuse me,

Dr. Mariam in a previous proceeding had recommended using all available data; did I understand your testimony correctly?

A. No, Dr. Mariam specifically recommended all available data that had gone through the Power Pool Bonneville normalizing exercise.

Q. All right.

A. So not the data prior to 1929 and not the data after 1978.

Q. All right.

And next we come to Mr. Lott's preferred recommendation, which is the most recent 40 years but using the filtering approach that Mr. Falkenberg recommends, right?

A. Yes.

Q. And that comes in pretty close to the number that you get in the line above if you just use all of the data since 1879 without filtering?

A. Yes.

Q. We see that if we actually filter, the next to the last line, if we actually filter the total amount of data we come with a number that's about $3 Million lower, correct?

A. Yes.

Q. Then we finally get to Mr. Falkenberg's

recommendation, and I think this is where you were going with Mr. Van Cleve, if we use his methodology which involves filtering and also use the years where there's really no sort of discussion about the quality or the preparation of the data, the point you were making earlier, use that for that 40 year time period out of that time slot, you come up with $82.2 Million as Mr. Falkenberg has recommended, right?
A. Yeah.
Q. I would like to go on to another area now and ask you to turn to your Cross Exhibit 175. This is not an entirely new area, still involves water, but this is Exhibit 175, and it's the response to Public Counsel 118. Do you have that?
A. I have the data request in front of me, and I'm familiar with the data and the graphs that it's referring to.
Q. Okay. Now if you turn to page 2 of the data request, you see several columns of numbers. These indicate this is streamflow data for these four different locations, correct?
A. Yes.
Q. And what's the units that are -- what are the units that are stated here?
A. Second foot days.

Q. Second foot days?

A. CFS over time.

Q. Okay, cubic feet per second over time?

A. Cubic feet per second over a day, yes. Cubic foot per second day I guess isn't the right way to say it, but it's synonymous.

Q. If we go to page 4 of the exhibit, we see --

A. All right.

Q. Are you --

A. Just actually as you get into more detail, I wanted to make sure that I had the rest of that. I have -- I actually only have the first sheet. I can pull it out.

MR. MEYER: May I approach the witness?

A. Okay, I have the whole exhibit, you said page 3 or 4?

Q. Page 4 at the end of the tables.

A. All right.

Q. Okay. And at the bottom there at the end of the tables there are ranges of years represented, and those represent the averages over this period of time taken from this table, correct?

A. Yes.

Q. And that's for each one of these locations, and it's not marked on page 4, but from left to right that's The Dalles, Priest Rapids, Spokane, Clark Fork, correct?

A. Yes.

Q. Now reviewing that document, isn't it true that in the column titled Priest Rapids the year 2000 is basically an average year? If we look up at the number for 2000 it's 119,000, and then we can see down below the averages for different time periods.

A. It's just modestly higher than what I would term a long-run average but -- so within a few percentage points anyway.

Q. All right. And let's compare it to the 60 years time period that the company is using in this case, which is 1929 to 1988, correct?

A. That was prior to settlement, but the initial filing, the 60 year filing, yes.

Q. Okay. And is the settlement time period shown here, that's the '29 to '78 period?

A. Yes.

Q. Okay, so it's slightly below that number. And if we look at the year 2001, that would appear to be the driest year at Priest Rapids in the entire database, correct, that's 75,000?

A. That's my recollection, I mean subject to check, yes.

Q. Would you please turn to Exhibit 145, that is an exhibit that was identified for Ms. Knox.

A. Okay.

Q. It was Public Counsel Data Request 215.

A. I will probably need a copy of that as well.

MR. MEYER: Just a moment, please.

And again the number was?

MR. FFITCH: It's exhibit 145, response to Data Request 215.

MR. MEYER: Thank you.

THE WITNESS: I've got it, I have it before me.

MR. FFITCH: Okay, thanks.

BY MR. FFITCH:

Q. Now do you recognize these excerpts as pages that we printed coming from one of the documents that you identified here on the cover sheet to the data request?

A. Yes, this was from one of our technical advisory committee meetings, one of the early ones for our 2005 integrated resource plan.

Q. All right. And the 2005 plan has not yet been finalized, correct?

A. It has actually been put out, it's been filed with the Commission.

Q. Okay.
A. Actually, I think the date on this is wrong, I think that actually that was a 2005 document, not a 2004 document. I didn't have either of these staff in my group in early 2004.
Q. All right. Well, at the time this data request was provided in August, the 2005 IRP had not been released?
A. In August, it was released in draft, it was available in draft form.
Q. Okay.
A. But not in final.
Q. The only reason I'm asking these questions is to indicate why in this document we weren't going right to the IRP.
A. Sure.
Q. And you can let me know if that's significant in terms of the numbers that we've got here. But another question for you, the reason we're asking you about one of Ms. Knox's cross exhibits is that this was prepared by you, correct, and you were identified as the witness?
A. Actually, this was prepared by an analyst who works in my department and works for me, so I didn't prepare it specifically. As you can see from page 2 of

3, it's got James Dahl and John Lyons on it.
Q. Okay.
A. So two analysts in my department.
Q. All right.
A. And I am familiar obviously with the table.
Q. You're identified as the witness in any event for this exhibit?
A. Yeah.
Q. Can I get you to turn to the page marked new resource summary, please, that's page 3 of the exhibit.
A. Okay.
Q. And look at the second and third lines, same area that we looked at with Ms. Knox, and this is information that's responsive to our request for cost data on simple cycle combustion turbines, correct?
A. Yes.
Q. And that's what SCCT stands for, simple cycle combustion turbine?
A. Yes.
Q. And the two lines, second and third line, show us that for the Arrow combustion turbine the capital cost is $672 per kilowatt and for the industrial $420 per kilowatt, correct?
A. Yes, the installed cost.
Q. So the Arrow costs about 50% more to build?

A. It does, yes.

Q. And if we compare the fixed and variable operations and maintenance expense, which is two columns over, the Arrow is also the more expensive for this category of expense, correct?

A. It is.

Q. And then we go two columns over again to the transmission costs, and we see that the Arrow has a transmission cost but the industrial does not, in other words the cost is zero?

A. Yes.

Q. For the industrial. So all the way around, the Arrow is a more expensive item except for the fuel; isn't that correct?

A. Yes, that's the advantage of the Arrow derivative unit is in exchange of higher costs for capital and fixed O&M you end up with a less cost to fuel the turbine. In other words, it uses less gas to make a unit of electricity.

Q. Right, I think you anticipated my next question, which is if we look over at the fuel column we see that the Arrow has a lower heat rate, meaning it uses less fuel per kilowatt hour of electricity, correct?

A. Yes.

Q. Would you agree that if you were only going to operate a single cycle combustion turbine for 200 hours per year for so-called needle peaking purposes, you would be more likely to choose the industrial option?

A. There are going to be circumstances where you might not choose that resource, and it gets back to the size. Think of Avista's system. You know, we own about 2,000 megawatts of capacity. You get some economies of scale in these industrial units. Although we have identified it as a 47 megawatt unit, if you land one 47 megawatt unit, you may well have a higher capital cost. For the integrated resource plan, we were looking at more of a turbine farm approach so you can bring the capital costs down. So I wouldn't say today that the company would not build an Arrow derivative peaker. I mean one thing, nice thing about Arrow derivatives is they are, you know, the economies of scale aren't as great, which means you can build smaller ones maybe more cost effectively, so. But certainly if you had a choice and you could get those economies of scale, the industrial size unit just for pure peaking purposes would be, you know, a more cost effective option.

Q. Well, maybe you have already answered this, but if you were going to operate it many more hours per

year than just for needle peaking, more of an
intermediate plant, wouldn't the Arrow make a more
economical choice because of the better heat rate?
A. I wouldn't define either of these plants as
intermediate type resources. They both still fall into
the peaking category.
Q. And just for clarification purposes on the
record, can you explain what the term needle peaking
means?
A. Actually, I would ask you to define that.
That's not a term I use regularly. The first time I
have heard it I think actually was inside this
proceeding.
Q. Well, I'm certainly not an expert in this
area and I'm not going to testify, but the intent of the
question was to focus on, you know, limited peaks.
A. Short-term peaking needs.
Q. Short-term peaking, is that a fair synonym if
you would?
A. Whether it's to represent units that aren't
used very often? I guess the question isn't clear to me
any longer.
Q. Well, it has to do with not as much the units
but just the demand you're trying to meet. Let's leave
it at short-term peaking.

A. Okay. And would these be units we might use for that, is that the question then?

Q. Well, I'm not sure if we really need to get tangled up. I had originally asked you if you were only looking to meet needle peaking purposes if you're only going to operate a single cycle combustion turbine for 200 hours a year for those purposes, you would be more likely to choose the industrial option, wouldn't you? That was my question.

A. If my only choice was to build one of these two options and I could get the economies of scale identified here and the capital costs, I think that would be a fair analysis. I don't know where the 200 hours comes except from a Puget plan IRP that was done a long time ago.

MR. FFITCH: Okay, that's all I have for this witness, Your Honor.

JUDGE CAILLE: Redirect?

MR. MEYER: Yes, briefly.

R E D I R E C T E X A M I N A T I O N

BY MR. MEYER:

Q. Let's sort of in reverse order return to Mr. Lott's testimony at page 14, that's Exhibit 287, there was a table there that you were asked about.

A. Okay, I'm there.

Q. And I believe Mr. ffitch walked you through the different methodologies displayed on that table. Do you recall that exchange?

A. I sure do.

Q. And in that regard, did the company pick the methodology with the highest cost impact, or were there other methodologies that could have been selected that would have had a higher cost impact as reflected on the second column?

A. Well, that's one of my concerns when I see a table like this, it would imply that the company did exactly that exercise. Indeed the company did not do that exercise. We emulated how we do our long-term planning and then we agreed in settlement to use a 50 year average. There are, if your question is are there periods of time where prices are higher, there surely are. There would be times where the prices were higher if that was the exercise one was trying to perform here.

Q. I see. So in the universe of possible methodologies, one could have arrived at yet a different methodology which would have produced a higher cost impact than what the company shows?

A. Yes, that's true.

Q. Okay. Now would you refer back to your rebuttal testimony. I'm going to ask you about a couple of illustrations.

JUDGE CAILLE: And that's Exhibit 174.

Q. It is, thank you, 174. There were a few illustrations that you were questioned about, and let's begin with the illustration on page 8, that's illustration number 3.

A. Okay.

Q. What does that purport to represent?

A. On illustration number 3?

Q. Yes.

A. I think first what I would do is I would step back to illustration number 2, and illustration number 2 is showing the annual deviation from the long run average in hydro streamflow. And you can see here there's many years above and below the line. In reviewing some of the work Mr. Falkenberg that say that he talked about, it was a 250 year look back at the conditions, there was an interesting comment in there, the comment from that study that tree ring study, the period from 1950 to 1987 is anomalous in the context of this record for having no notable multiyear drought events. So that was rather interesting, and here it's somewhat hard to see. I mean my eyes after having looked at this data for quite a while, I can see that trend.

But what happened then if you flip the page to illustration number 3 on page 8, you can see here where essentially all I did was roll this, do a five year rolling average, so you really can see what's going on here. And you see there are a few years that are below average, but that period of time is predominantly well above average in almost every period of that, you know, when you do a five year rolling average. And that really illustrates what that tree ring study purported to explain. And that's really what these are all about. If you look at the record itself and you go back in time, you can see other areas both before that 40 year period and then after that 40 year period where you have rolling five year averages that are well below the line, the mean value.

Q. And so illustration number 3 in addition to including that data also has brackets, if you will, depicting Mr. Falkenberg's beginning and end point in the 40 years hydro study?

A. Yes, that's true.

Q. And again, Mr. Falkenberg not only limits it to 40 years, but then filters out approximately a third of those observations; is that correct?

A. I believe his analysis, he has 40 years, when he gets done filtering he's only remaining with -- he has 24 years left, so I don't know what the math is on that, 16 of 40, so about -- I guess that's about your number.

Q. Could we turn lastly to illustration number 6, and that is on page 18 of that same exhibit.

A. I'm there.

Q. You were asked questions about that, what's the point of this illustration?

A. Yes, I got -- received as part of a working paper from Mr. Falkenberg his methodology for dispatching our hydro plants, and we talked earlier about the fact that he had minimum and maximum numbers from Aurora so -- and my interpretation was that the -- his belief there is that accounted for all reserves and all the operational constraints. But what it did, that model did, is it literally sorted market prices from the highest price to the lowest and then just simply moved the hydro either to run at one of two levels like a light switch, and we can see it in the description here, you're at 460 or you're at 40 megawatts, on or off, and you can see there's lots of hourly on-off's in here. This only represents 168 hours, could have put more in there, but I really wanted to show how many times you have these needle peaks, to use Mr. ffitch's term, we really -- this isn't realistic relative to how we run our models.

One thing the way Mr. Falkenberg's work was done on that spreadsheet, it really didn't put the information chronologically, so you couldn't look and see, is this a reasonable hydro dispatch or not. So I was able to go back in, do the prices, and re-sort, and put the data into chronological order so I could prepare this information so we could see exactly what was going on here. And in my professional opinion, you can not run a hydro system like this.

There was an illustration earlier in my testimony, if we wanted to go there for a moment -- well, let's not do that, just really shows how historically we have operated our units. We really can't run our plants this way, that's the bottom line.

Q. That's the bottom line, okay.

MR. MEYER: That's all I have, thank you.

JUDGE CAILLE: Did you have some --

MR. VAN CLEVE: Yes, Your Honor, I just had one follow up on the questioning about illustration number 3.

JUDGE CAILLE: Go ahead, Mr. Van Cleve.

R E C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Now for this illustration, Mr. Kalich, you used a rolling average methodology; is that right?

A. That's correct.

Q. And are you aware that in the Puget case that we were talking about earlier that Dr. Dubin testified according to the Commission's order to the well-recognized statistical theorum that the use of rolling averages may produce cycles that are not actually present?

A. And that's a strong concern I have with using the rolling, the 40 year rolling average. So again here we're not talking about calculating power supply expenses, we're looking at just a simple amount of streamflow in a river.

Q. So you would agree that your technique here may show cycles that are not actually present?

A. I don't think this indicates a cycle. What it shows is a bias of high flow water years. There's no cycle here per se.

MR. VAN CLEVE: Thank you, that's all I have.

JUDGE CAILLE: Commissioners, any questions?

COMMISSIONER OSHIE: Yes, thank you.

MR. FFITCH: I'm sorry, if I may interject, Your Honor, I did have also a couple of recross questions, and I'm happy to take them whenever you want me to.

JUDGE CAILLE: Why don't you go ahead now.

R E C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Mr. Kalich, on redirect you were asked about other hydro normalization methodologies that yield higher numbers, are any of those alternate methodologies described in the record of this case?

A. The data is described in there, but if you mean is there a calculation at the bottom of a page that comes to those values, the averaging has not been done, all the data is on the record.

Q. Is there any testimony from any party about any of these other methods that yield a higher cost impact?

A. No. Again, I am actually concerned that this is the way we're looking at the problem. I think we ought to really go back and look at how Dr. Mariam and Dr. Dubin in their professional trainings have provided really I think the approach to use, really ought to be looking at what the data entails and from what you learn from the data actually determine an approach to normalizing your hydro.

Q. Well, that's not really what I'm asking. Your counsel indicated to you or asked you if there were and got you to agree that there were other hydro normalization methodologies that could have been employed to yield even higher cost impact numbers than those shown on Mr. Lott's table.

A. Yes.

Q. And I'm asking you if there is any testimony or any, well, any testimony in the record describing what those methodologies are.

A. There's not.

Q. And are you aware of any order of this Commission over the last 30 years or more adopting any other hydro normalization methodologies that yield a higher cost impact result than any of those shown on this document?

A. It would depend on how you define it. Actually one of the methodologies would be defined as a rolling 40 average assuming that you were back, you're back 30 years, so that would be -- it wouldn't quite do it, the 1928 through 1968, the 40 year period ending in 1968 is one of the examples. So if you -- basically it's still the same methodology, the question is how far back do you roll the clock in time.

Q. It's the same methodology, is it not, the rolling 40 year average that was approved by this Commission?

A. It would be that methodology but backed up in time.

Q. Right, but I'm asking you about other methodologies as was put to you by your counsel that at least as the question implied could have been used to jack up this number but were not, and can you point to any Commission orders where there's ever been approval for any such alternate methodology, whatever it might be?

A. I must have misunderstood my counsel's question, because I wasn't thinking of methodologies in terms of filtering or any other type of new approach. I was referring only to like that 40 year rolling average, so I guess for the record there are no other methodologies that are being testified to here today.

Q. All right.

A. By me.

MR. FFITCH: Thank you.

JUDGE CAILLE: Commissioner Oshie.

E X A M I N A T I O N

BY COMMISSIONER OSHIE:

Q. Mr. Kalich, I have just a clarifying question, and it really relates back to your cross-examination by Mr. Van Cleve, and it's you testified that there, of course, there is a difference in cost between your at least what was originally proposed by the company, the 60 year hydro study, and the 50 year study that was accepted by the company in the settlement and agreed upon by the settling parties. And the question relates directly to where is that found in the workpapers, and I believe that you stated that it was in Exhibit 11 in the table that was provided in Mr. Norwood's testimony and that the difference in cost is reflected in the CS2 fuel allocation, if you will, that's contained on page 5 of Exhibit 11. Now did I understand it correctly?

A. Actually, I was in error in that statement I learned after I got off the stand. What I was looking at in the discussion I had at that time was the numbers, the relative magnitude, and the numbers looked about right, but my understanding after that comment was actually that was some basically -- I'm at a loss for the term, I'm a little embarrassed here, but anyway increasing, basically adjusting that expense into a revenue requirement.

Q. And so where then is it found, anywhere in the settlement document so that when we want to look back at this we can find it to determine how it's reflected in the final numbers?

A. I think ultimately, as I explained earlier in Mr. Van Cleve's questioning, it wasn't included in that settlement value.

Q. All right, thank you.

A. No, that was an oversight.

E X A M I N A T I O N

BY COMMISSIONER JONES:

Q. Mr. Kalich, my question relates to the Aurora model, and I think Mr. Falkenberg in his testimony suggests that perhaps the model deserves extra scrutiny because it's never been used in a rate case by this company before. Is that your understanding, that the Aurora model has never been used in a rate case for this company?

A. This is the first time in this jurisdiction that we have used Aurora for rate filings. We have filed two integrated resource plans using the document.

Q. Right.

A. And then of course as we mentioned as I think we learned earlier in Idaho we filed a case recently with Aurora.

Q. Based on your statements in the rebuttal, however, are you aware of any flaw either in the inputs or in the way it models the hydro system or the thermal system in which you believe that this Commission should give extra scrutiny to the Aurora model given the fact that I think in your -- on page 3 you say that among clients in the industry there's Bonneville Power Administration where you used to work and I assume you used the model when you were employed there and other utilities in the region utilize this model?

A. Yeah, this model is in the Northwest and even across -- I will say definitely in the Northwest has become industry standard, Northwest Power and Conservation Council. I had a list, I don't need to reiterate those obviously. What I point out to people with the Aurora really is what -- my opinion where I would spend the time scrutinizing is on the inputs into the model. The methodology, the reason this model has been selected by the Power Council more than a decade ago or about a decade ago now and going forward and all the utilities have moved to it is because of its exceptional job of dealing with the hydro resource we have here in the Northwest. One of the individuals from the council I alluded to actually went over and now works for EPIS and has really enhanced a lot of the capabilities of that tool. So I'm not concerned at all, I think the model does a phenomenal job, and I have used other tools and looked at Midas Gold and some of the other industries, IPM, there's a bunch of these tools, and in my opinion this model is far and away a superior tool.

Q. And lastly, help me with the difference between what you have called "streamflow data" and then "data adjusted by the Northwest Power Pool"?

A. Okay.

Q. What is the difference?

A. Streamflow is exactly that. You put a gauge in the river, and you measure how much flow comes by the gauge. As you look back in the record back in time before a lot of the changes to the river systems occurred due to, you know, fisheries, a lot of the fisheries, environmental, and then even get back further where you're pulling dams out of the river, back further before we had as much agriculture as we do in the Northwest, are referred to non-linear rela -- non-linear terms here in this proceeding, and those are what I would define as non-linear. And what one needs to be able to do to normalize this data is essentially take today's conditions and back cast, for lack of a better term, back cast what streamflow -- based on the streamflow recorded at those gauges how those would have changed were those streams flows in 1929 to have come down through the river system today. And as you know, there's storage on the hydro system that affects when the water comes down whether month to month or even year to year on the Canadian system as far as storage. So it's real important to get those right. Streamflow isn't always a great indicator of ultimately what type of generation you can get, you know, once you get those streamflows actually occurred again on our existing system today.

Q. So some of those adjustments are covered in your rebuttal testimony when you list on page 15 the 10 reasons limiting hydro capability, and I think you just alluded to several of them, environmental restrictions such as flows, operating reserves, things like this?

A. There's a lot of overlap there, yes.

COMMISSIONER JONES: Okay, thank you.

JUDGE CAILLE: Anything further for this witness?

All right, thank you, Mr. Kalich, you're excused.

Mr. Ron Peterson.

Mr. Van Cleve, are you going to go first on Mr. Peterson or Mr. ffitch?

MR. FFITCH: Your Honor, in the event Public Counsel has no cross for this witness, I guess I would only ask if something comes up on the cross of Mr. Van Cleve that I might follow up on.

JUDGE CAILLE: All right.

(Witness Ronald R. Peterson was sworn.)

JUDGE CAILLE: Thank you.

MR. MEYER: Thank you.

Whereupon,

RONALD R. PETERSON,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Peterson, for the record, please state your name and your employer.

A. My name is Ronald Peterson, and I'm employed by Avista Corporation.

Q. And have you prepared prefiled direct testimony marked as Exhibit 81?

A. Yes, I have.

Q. And any corrections to make to that?

A. None.

Q. Are you also sponsoring what have been marked for identification as Exhibits 82 through 94?

A. Yes.

Q. Were those prepared by you or under your direction and supervision?

A. Yes, they were.

Q. Is the information contained therein true and correct?

A. Yes.

MR. MEYER: With that, Your Honor, I move the admission of Exhibits 81 through 94.

JUDGE CAILLE: Is there any objection?

Then Exhibits 81 through 94 are admitted into the record.

And, Mr. Van Cleve, the witness is available for your cross.

MR. VAN CLEVE: Thank you.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. If you could, Mr. Peterson, refer to Exhibit 96 and also attached to that is Exhibit 96C.

A. I have that.

Q. And is the risk policy that's in this data response, is that the primary tool that the company uses to manage its natural gas price risk?

A. It's one of the tools we use, I would say yes, it's the primary one.

Q. And in your testimony at page 7 at line 1 --

JUDGE CAILLE: Excuse me, could you please identify the exhibit.

MR. VAN CLEVE: That would be Exhibit --

JUDGE CAILLE: 81?

MR. VAN CLEVE: 81, yes, thank you.

JUDGE CAILLE: And the page number, I'm sorry?

MR. VAN CLEVE: Page 7, line 1.

THE WITNESS: I'm there.

BY MR. VAN CLEVE:

Q. It says:

The purpose of the risk policy is not to develop a specific procurement strategy for buying or selling power or natural gas fuel for generation at any particular time.

Can you explain what that means?

A. The purpose of the risk policy is to try to manage the company's exposure to open power positions. And what I mean by that is we have a variety of resources that we can meet our retail load with. We have talked about those on and off for the last day or two. We have base load resources such as Colstrip, Coyote Springs, our hydro generation. And we have peaking resources. We also have a load that we need to meet. And what we try to do in our risk management process is look forward to what those loads and resources will be at different points in time. When we do that, then we can see if we have an open power position. In other words, we might be short of energy to meet our loads, or we might be long energy to meet our loads. Based on looking at that, and we look out about 18 months, we will then make decisions about whether we need to acquire additional power. And that power can be acquired by purchasing gas to run a gas resource or by buying power in the open market. And what we do is we make an economic choice based on whichever is the least cost for customers.

Q. If you refer to page 3 of Exhibit 96, I'm referring to exhibit page 30, Exhibit 96C, that's the first page of the risk policy.

A. I'm there.

Q. And it says on the lower left-hand corner that it was revised November 9th, 2000; is that right?

A. Yes.

Q. And have you thought about revising it since then?

A. Our risk manager has actually worked on revisions to this policy. I think there may be some supplements that aren't included in here. As I looked through this, I noted that this still had the -- allowed the gas procurement activity being done by Avista Energy, and of course that's not the case today. So there may be a more recent version of this which I don't have with me.

Q. And would you agree that risk management practices have become significantly more sophisticated in the last five years in the energy industry?

A. As compared to what?

Q. As compared to what they were in 2000.

A. I think companies have learned a lot in 2000-2001, and actually a lot of the knowledge and expertise that occurred and changed was at that time, and that was in response to the Western energy crisis.

Q. I would like to refer you just briefly to a page in Mr. Johnson's direct testimony, which is Exhibit 181.

A. I don't think I have that.

MR. MEYER: Just a moment, we'll have to get to it. Which page?

MR. VAN CLEVE: Page 12.
THE WITNESS: It's coming.
A. Okay, I'm on page 12, Exhibit 182.
BY MR. VAN CLEVE:
Q. Okay, now this shows the increase in power supply expense that the company is requesting in this case.
JUDGE CAILLE: Excuse me, this is Exhibit 181, isn't it?
THE WITNESS: Oh, excuse me, yes it is 181, I'm at the right page I think.
BY MR. VAN CLEVE:
Q. I'm sorry, I have you on the wrong page, if you could look at page 8 at line 19.
A. Okay.
Q. And it says there that:
The natural gas expense in the pro forma totals $70 Million, which is an increase of almost $50 Million from the test year.
Is that right?
A. That's correct.
Q. And it says that:
The increase is primarily due to the addition of the second half of Coyote

Springs 2.

Is that right?

A. That's what it says.

Q. So would you agree that adding the second half of Coyote Springs 2 substantially increased the gas risk of the company?

A. Yes, I would.

Q. And when the company decided to make that acquisition, did it develop a gas hedging strategy for Coyote Springs 2?

A. Again, you have to think back to the way we manage our power positions, and it's not about speculating about gas prices and where gas prices are going to go, it's about managing open power positions and fueling the most economic resource for our customers at any point in time. Again, the way we do that is we look out to the future, we balance our loads versus our resources, and then we make a decision on whether we should buy fuel or buy power. We actually do hedge gas for Coyote Springs over time when it's economic to do so. We look out 18 months, and we layer in gas purchases when our risk management guidelines say that you have an open power position that needs to be filled. I think Mr. Norwood talked about that yesterday, but if you don't recall, we have actually hedged 40% of our gas needs for Coyote Springs through the end of 2006, and the average price that we have hedged is around $7.34.

Q. So in other words, 60% of your gas needs for the test year ar unhedged?

A. At this point in time. Now it's important to remember what I was just talking about. We have risk management meetings monthly where we evaluate our open power positions and decide when it's appropriate to fuel Coyote Springs 2. So between now and the time we get to running the plant in 2006, if it's economic we will have hedged that gas. When we go into the day, if Coyote Springs 2 is economic to run, we would have purchased the gas ahead of time. The only time we're actually in the spot market is if there is an economic decision during that day where Coyote Springs 2 might be in the money or out of the money, and then we'll buy or sell gas to take care of that. But as you get to the month ahead and we're going to be needing Coyote Springs 2, it's already been hedged.

Q. So would it surprise you to learn that most of the other industrial utilities in the Northwest have much less of their needs exposed in gas market for 2006?

A. I think each utility is going to operate under their own set of risk management policies and guidelines. Some may have hedged all of their gas, some may have hedged none of it, so it wouldn't surprise me to see that we're all very different.

Q. And the process that you have to determine whether to hedge gas or not just looks at the differential between gas and electric prices; is that right?

A. That's one factor. It also looks at whether we actually need that particular generation asset to meet our retail loads. One thing I might mention is that when we don't need Coyote to meet retail loads, if it happens to be economic to purchase gas and run the facilities and sell the power in the open market, we'll do that, and that benefit gets passed through to customers.

Q. If you could refer to Exhibit 97.

A. Yes.

Q. This is a data response that describes what your fuel acquisition policy is, correct?

A. Yes, it is.

Q. And you state in here, and it's five lines up from the bottom of the second paragraph, that the company does not attempt to model potential future gas or electric prices, and I think you also say that in your testimony; is that right?

A. That's right. What we use are actual forward prices for both of those commodities for as far out as we can get them and periods that you can actually do a trade, but we do not attempt to forecast where those prices might go.

Q. So --

A. In the short term. Mr. Kalich does do some modeling in terms of long-term planning under the IRP.

Q. So given that the company doesn't predict where gas or electric prices are going to go, would the company ever enter into a gas contract that was longer than 18 months?

A. I think that's a fair question. You know, the company has done that in the past without a lot of support, but I think given the volatility that we have seen in the gas price market in the last year, it's something that's important to look at, and we are actually studying that at this point for both the gas distribution company as well as the generation part of our business. I think it's very important that we would review that information with the Commission and the Commission Staff to make sure that they understand and are comfortable with that. Because once you start locking in longer term gas, you're actually speculating on where the gas prices are going to be two or three or four years into the future.

Q. And to the extent that the company doesn't hedge its gas risk, is that passed on to customers through the ERM after the 10% sharing and the deadband?

A. Again, we do hedge our gas risk, the only question is when we do it. But to the extent the price that we hedge at is different than what would be built into this settlement or a general rate case, the difference would go through the ERM. I would like to point out that in this particular case, we have agreed to a gas price of $7.25 in the settlement. As I mentioned to you a moment ago, our hedges to date are at $7.34, forward gas prices for this winter are in the $12 to $13 range. The lowest prices that we see for 2006 are in the $9 range. And so I think the price that we have set in the settlement is probably less than we're actually going to experience.

Q. And doesn't reducing the ERM deadband from $9 Million to $3 Million, doesn't that increase the exposure of customers to this risk of having 60% of the gas supply unhedged for 2006?

A. I think you have multiple questions there, can you restate that, please.

Q. Sure. Doesn't decreasing the deadband basically increase the exposure to gas risks that customers bear?

A. That would go both ways. Gas prices go down, they get the benefit. Gas prices go up, they would share in the risk.

Q. Right, but you have just testified that you expect them to be higher rather than lower --

A. Right.

Q. -- than what's in the stipulation.

A. And that's for just the upcoming year. I can't tell you what happens beyond that.

Q. And who do you think is in a better position to manage that gas risk, customers or the company?

A. The company clearly.

Q. Referring back to the risk policy, Exhibit 96C at page 5.

A. I'm there.

Q. In the second paragraph 6 or 7 lines up from the bottom of that under use of derivatives, there's a sentence that says:

Hedging transactions will be entered only after an assessment of the economic effect is analyzed and the accounting treatment is analyzed.

A. Are you looking at page 5 on the top of the page?

Q. Yes, I'm on page 5 at the top of the page.

A. Sorry, you need to redirect me again here.
Q. It's under use of derivatives in the second paragraph.
A. Okay.
Q. And it's talking about hedging transactions being entered into only after the accounting treatment is analyzed. And my question is, when you're analyzing the accounting treatment, are you looking at whether the cost of the hedge can be passed through the ERM?
A. No, that wasn't the intent of that language. These derivative products can be quite complicated, and the accounting profession has come up with some very complex rules over the last several years, and we want to make sure that we're not entering into some derivative that ends up with a non-intended impact on our financial statements. So that's why we include our accountants whenever we're doing some sort of transaction that we haven't done before.
Q. If you could refer back to page 3 of Exhibit 96 under the heading the company philosophy toward risk.
A. I'm there.
Q. It says in the last sentence of that first paragraph:

While management acknowledges that income certainty is impossible, the

company's tolerance for earnings volatility from the utility's operations is targeted not to exceed 20% of the utility's normal annual earnings.
Is that right?
A. Yes.
Q. And does that mean that the risk really isn't a concern to the company if the cost can be passed through to customers under the ERM?
A. It doesn't mean that at all.
Q. Then why is the focus on normalizing or maintaining an earnings range rather than holding down costs to customers?
A. The risk management policy is really developed as a way to look at overall corporate risk, and as the board reviews risks one of the things they look at is what the potential impact of that risk could be on the company's bottom line, and I think that's what this is intended to convey.
Q. If you could now turn to Exhibit 98, which is another data response.
A. Okay.
Q. Doesn't this response really indicate that the company has no way to determine whether it would be prudent to make a longer term gas purchase compared to a

short-term purchase?

A. I think as we have already established, the company does not try to predict prices, and we do not speculate on where prices are going to go. I think there are many algorithms and techniques available to try to predict what prices are going to be, the only thing I know about them is that they're all going to be wrong, and I don't think it's our position that we want to take a position where we would speculate on whether prices are going up or down. That doesn't mean we shouldn't look at other kinds of hedging. And as we analyze this to the future, if we find that hedging a portion of our gas for longer terms such as three or five years makes sense, then we would bring that to this Commission to discuss it and see if they agree. But at this point, I'm not willing to speculate and take a risk on where prices are going to go, too many things out of our control.

Q. Now you did mention a little earlier that the company had made some longer term gas purchases a few years ago, and you said that there wasn't support for it; what did you mean by that?

A. I think we're all familiar with the proceeding in 2001 and 2002. Actually that was the birth of the ERM. Part of that, I think as was discussed by Staff, was that the $9 Million deadband was essentially put in place because the company had entered into longer term gas contracts that at that time turned out to be out of the market, and in hindsight it was determined that the company should pay the consequences for that. Those gas prices by the way happened to be $6, I would like to have that back today. But those were longer term contracts, and we didn't get a lot of support for having entered into them.

Q. That case where the ERM was developed, that was settled, right?

A. Yes.

Q. And you absorbed some of the costs of those out of market contracts through the ERM, right?

A. Yes, we did.

Q. So you agreed to a settlement where you absorbed those costs, right?

A. We did that. Basically we found out what the litigation position of the other parties was going to be, and it was going to be for disallowance of all of those costs that were over the market price.

Q. So is it fair to say that your gas procurement strategy is designed to avoid disallowances rather than minimize costs?

A. Absolutely not.

Q. If you could turn to page 28 of your direct testimony, which is Exhibit 81.

A. Okay.

Q. This is the section of your testimony where you're proposing to eliminate the deadband in the ERM, correct?

A. Yes.

Q. And in line 11 it states that:

> The ERM was designed to provide recovery of costs that are beyond the reasonable control of the company.

Is that right?

A. That's what it says.

Q. And is it your position that the company doesn't have any control over gas costs?

A. We don't control the market price of gas obviously. We can control when we decide to buy or hedge gas. That would be the extent of our control. But I can't tell you whether prices a year from now are going to be higher than they are today or lower than they are today. The best I can do is try to manage my open power positions with the most economic resource that is available at the time.

Q. If you could turn to page 30 of your direct testimony, Exhibit 81.

A. Okay.

Q. This paragraph that starts at line 5, what are you trying to show with that paragraph?

A. What that is trying to illustrate is the volatility in our power costs that can result from changes in gas prices.

Q. And I guess what confuses me about this example is that it says that a $1 change results in $10.2 Million in cost changes; is that right?

A. Yes.

Q. But when I look at the settlement stipulation where the gas cost was increased by $1.28, the adjustment to power cost was only $3.6 Million, so I'm wondering why that is?

A. That's a good question, I don't have an answer.

Q. Could it be that the company benefits from higher gas costs because it's a net seller in the market and that that offsets some of those costs that are --

A. Could very possibly be, yes. I would have to ask Mr. Kalich to go through the details of his model on that.

Q. Now the company is proposing a substantial increase in its power costs in this case, correct?

A. Yes.

Q. But it's not proposing or it's proposing to eliminate the deadband?

A. That's correct.

Q. Now if you looked at the deadband as the company sharing a percentage risk of its power costs, that percentage would actually go down if you didn't change the deadband, right?

A. Yes, I understand your math.

MR. VAN CLEVE: Thank you, that's all I have.

JUDGE CAILLE: Mr. ffitch, do you have any cross?

MR. FFITCH: No, thank you, Your Honor.

JUDGE CAILLE: Redirect, Mr. Meyer?

MR. MEYER: No redirect, thank you.

JUDGE CAILLE: Any questions from the Commission?

COMMISSIONER OSHIE: No questions.

CHAIRMAN SIDRAN: This may be directed to counsel rather than to the witness, but going back to Mr. ffitch's inquiry with respect to, if I understood the witness correctly, with respect to the response to the request that he was referring to, which is Exhibit Number 96, it asks the company to please supply a copy of the current Avista risk management document, which I take your testimony to be this is not the current document.

THE WITNESS: I know our risk manager has been working on a new updated policy. I'm just not sure where that is, if it's been completed or is in a draft stage.

CHAIRMAN SIDRAN: I would ask that, counsel, you confirm whether this document which is dated 2000 is current, and if it's not, then please provide the response to the request.

MR. MEYER: And we would be happy to do that, and we'll take that I assume as a record requisition.

JUDGE CAILLE: Yes, a Bench Request.

MR. MEYER: Got you.

CHAIRMAN SIDRAN: That's all.

MR. MEYER: Thank you.

JUDGE CAILLE: You're excused, thank you very much.

(Discussion on the Bench.)

JUDGE CAILLE: All right, Mr. Johnson.

(Witness William G. Johnson was sworn.)

JUDGE CAILLE: Thank you.

Mr. Meyer.

MR. MEYER: Thank you.

Whereupon,

WILLIAM G. JOHNSON,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. MEYER:

Q. Mr. Johnson, for the record please state your name and your employer.

A. My name is William Johnson, I work for Avista Corporation.

Q. And have you prefiled direct testimony marked as Exhibit Number 181 as well as rebuttal testimony marked as 186?

A. Yes, I have.

Q. Any changes to those?

A. No.

Q. All right. So if I were to ask you the questions that appear therein, would your answers be the same?

A. Yes, they would.

Q. Are you also sponsoring what have been marked as Exhibits 182 through 185 as well as 187?

A. Yes.

Q. Were those prepared by you or under your direction and supervision?

A. Yes, they were.

MR. MEYER: With that, Your Honor, I move for the admission of Exhibits 181 through 187.

JUDGE CAILLE: Is there any objection to the admission of Exhibits 181 through 187?

Then they are admitted.

And, Mr. ffitch, were you going first?

MR. FFITCH: Your Honor, we have been having an arm wrestling match about who was going to go first because I was anticipating a little more time with preparing for this witness, we're moving pretty quickly here. Mr. Van Cleve indicates he's ready with a few questions to go ahead.

JUDGE CAILLE: All right.

C R O S S - E X A M I N A T I O N

BY MR. VAN CLEVE:

Q. Mr. Johnson, if you could look at your direct testimony, which is Exhibit 181, at page 12, now looking at the question that begins at line 9, and these are just clarifying questions, are these numbers Washington jurisdictional numbers?

A. These are system numbers.

Q. Okay. And do you have, is there somewhere in your testimony where you have the Washington jurisdictional numbers that equate to this?

A. I don't believe there is because of the way we do the ERM is we do it on a system basis and then do the Washington allocation after you change, take the changes in the system cost.

Q. And what's the allocation factor?

A. .6516.

Q. Okay. And do you know what these numbers are under the settlement stipulation?

A. No, we don't. We haven't made the calculations yet to derive these numbers for the settlement stipulation.

Q. But you will need that, you will need to do that in order to calculate the ERM?

A. Once we get a final order from this case, we'll calculate the ERM authorized expenses, yes.

Q. Okay.

And if you could refer to Exhibit 202 which was identified as a cross exhibit for you.

A. I'm there.

Q. Okay, based on our calculation of the average price of these gas prices, it was about $6.85, and Mr. Peterson testified to a different number, and I just wondered whether that was based on an update of gas purchases that had been made or where that came from?

A. I believe he's got an updated purchase sheet, because this was done as, well, it looks like -- I can't remember exactly when this was done, but he's got something more recent that has some additional purchases for 2006.

MR. VAN CLEVE: And, Your Honor, could we request that the company provide the update to this data response?

JUDGE CAILLE: So that is an update to Exhibit 202. Does the company know how soon it can provide that?

MR. MEYER: Just a moment.

We have just some stray marks, we can get you a clean copy perhaps in the morning and then supply it at that time.

JUDGE CAILLE: That would be great, thank you.

MR. VAN CLEVE: That's all I have.

JUDGE CAILLE: Mr. ffitch.

MR. FFITCH: Thank you, Your Honor. May I just have a moment to organize my papers here.

C R O S S - E X A M I N A T I O N

BY MR. FFITCH:

Q. Mr. Johnson, you were the respondent to

Public Counsel Data Request 232, were you not?

A. Which one was that?

Q. It's been marked as Exhibit 203 in the case, and it is the fuel mix report request.

A. Yes, I was.

Q. Do you have that in front of you?

A. Yes, I do.

Q. Again that's Exhibit 203, and there we asked the company provide the all-in cost per kilowatt hour for the test year for these various fuel mix components, correct?

A. That's correct.

Q. And you provided a worksheet to us, which is page 2 of the exhibit. Essentially this shows the cost of power for each type of resource on the system, correct?

A. That is correct.

Q. And I believe we looked at this already with a previous witness, I don't know if you were here in the room when we did that. We translated the dollars per megawatt hour into cents per kilowatt hour, among other things. Were you here for that?

A. Yes, I was.

Q. Okay. So I'm going to give you a chance to correct the math if you had any concerns there. And you provided that information for the year 2004, which is actual data, therefore it's a little different from the test year data in this case; is that right?

A. Well, yeah, I mean that would be the primary difference, that it's the test year. This is the test year, 2004, based on actual generation levels, actual fuel costs, plants. The pro forma is based on the modeled pro forma generation and pro forma fuel costs for the plants.

Q. All right, so they are a bit different?

A. They could be substantially different based on those differences, particularly for the natural gas fired plants would be substantially different.

Q. So the pro forma numbers that are provided in this case by the company for the test year 2004 are substantially different than the actual data shown on this exhibit, am I understanding?

A. What I'm saying is the costs can be very different in the pro forma year in this measurement of dollars per megawatt hour than it was in the test year, and that would primarily be for the natural gas resources. Because in the test year we didn't run the natural gas resources very much. We didn't have Coyote Springs available for a good portion of the year, so the denominator for megawatt hours is small, you end up with a very high number of dollars per megawatt hour for natural gas plants in the test year, you wouldn't end up with that high of a number in the pro forma.

Q. But the figures on this exhibit that we have in front of us are based on 2004 actual generation, right?

A. That's correct.

Q. Okay. Well, now if I can ask you to just refer to that as I ask a few questions. First for hydro power on the second line, that's a bit more than half of the total power supply for Avista, is it not?

A. It's roughly half, yes.

Q. And the cost is about 1.3 cents per kilowatt hour?

A. That's correct.

Q. And then second for coal, we're looking at about 20% of the utility's power supply, correct?

A. I don't know that for certain, but subject to check that sounds reasonable.

Q. All right. And that's 2.6 cents, 2.56 cents per kilowatt hour?

A. That is correct.

Q. So the coal on average costs about twice as much as the hydro, does it not?

A. That's roughly accurate.

Q. Now for the coal plant at Colstrip, there's also a dedicated transmission line where the company is a co-owner of, is there not, is it not?
A. There is, yes.
Q. And the company is a co-owner of it?
A. That's my understanding, yes.
Q. And those costs are not included in the costs shown here, are they?
A. I don't have the actual study in front of me, but I believe that this also included that portion of the transmission that is owned by the plant.
Q. All right, so you believe it is included here?
A. I believe that it is included here in these coal costs.
Q. All right. Now if you could look at the natural gas numbers, that figure in 2004 doesn't appear to include much of Coyote Springs; is that correct?
A. Well, we had an issue with Coyote Springs 2 transformer in 2004, so it wasn't available for approximately nine months of the year in 2004, so there is much less generation in 2004 from natural gas than we would normally expect.
Q. Well, do you have a sense of what the Coyote Springs addition would do to this line of the chart in

terms of total gas kilowatt hours and average costs per kilowatt hour?

A. No, I don't. But you could look in my pro forma and my exhibit and take the total generation and the total fuel costs and -- well, you couldn't even do that, because this is an all -- this is a total embedded cost. So no, I couldn't calculate that without actually having the numbers.

Q. What is the variable operating cost of Coyote Springs at current natural gas prices?

A. Well, to do that, you need to tell me what you pick as a current natural gas price. You need to define for the next day, for the next year. If you pick a number, I could tell you what it is.

Q. Well, why don't you pick a number.

A. Okay.

Q. I'm not testifying here.

A. Well, if we --

Q. You're working for the utility company that uses natural gas as a fuel, and I suspect that you would have more data from which to select than I would.

A. Well, if we take Mr. Peterson's testimony and say we're roughly a little over $7 a decatherm for gas, you would multiply it roughly times 7 as a 7,000 heat rate to come up with $49 a megawatt hour for the fuel costs of Coyote Springs 2.

Q. Okay. That's for the variable operating cost?

A. For the fuel, variable fuel costs.

Q. And there's also a capital cost component and fixed operation and a maintenance cost component for Coyote Springs as well, correct?

A. That's correct.

Q. So if you include all those things, I guess we're working towards an all end cost here, do you have a sense of what the total cost of Coyote Springs power is in the current gas market, let's say use that $7 figure that you were using before?

A. Based on our analysis when we decided to purchase the second half of Coyote, I believe there's probably around $20 a megawatt hour of fixed cost and fixed O&M embedded in the plant and then maybe a couple, there's a couple dollars of variable O&M, so we would have $49 plus $20 plus $2 as a total embedded cost with using $7 gas at Coyote Springs 2.

Q. So if I'm figuring this right, that would add up to something in excess of 7 cents per kilowatt hour for Coyote Springs power?

A. Roughly 7 cents, correct.

Q. So that's over four times the cost of hydro and twice the cost of coal, correct, using those?

A. Based on these numbers from 2004.

Q. So is it fair to sum up by saying that hydro is more than half the total supply and significantly cheaper on average, coal is about 20% of the total power supply and about average in cost, and natural gas is by far the most expensive major source of electric power to Avista; is that a fair summation?

A. I would agree that natural gas is the most expensive resource we have, yes.

Q. And if the company needed additional power to serve load growth, would that come from any of the cheaper sources here from hydro or coal, or would it most likely come from either a natural gas resource or the market?

A. It could come from a variety of sources. I mean we're looking at every source right now, and it could come from hydro upgrades, it could come from coal upgrades, it could come from coal plants, it could come from renewables, there's a variety of sources.

Q. Well, in terms of likelihood, isn't it more likely that it would come from a natural gas resource or from the market rather than hydro or coal?

A. I'm really not -- I don't think I can speculate on where we would secure our next resource from.

Q. But the margin, whether it comes from a company owned resource or from purchase power, is more likely to be a natural gas resource in most cases, isn't it?

A. Can you repeat that question.

Q. At the margin, whether this new additional power comes from a company owned resource or from purchase power, it's more likely to be a natural gas resource in most cases, isn't it?

A. I wouldn't agree with that, no.

MR. FFITCH: Your Honor, I do have some other cross, that is the end of that particular line of questioning.

JUDGE CAILLE: All right, we will conclude for today and pick this up tomorrow morning.

The witness is excused for now, thank you.

(Hearing adjourned at 5:05 p.m.)