Exhibit No. ___T (APB-1T)
Docket No. UE-060181
Witness: Alan P. Buckley

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of AVISTA CORPORATION, d/b/a AVISTA UTILITIES, For Continuation of the Company's Energy Recovery Mechanism, with Certain Modifications	DOCKET NO. UE-060181

TESTIMONY OF

ALAN P. BUCKLEY

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

April 21, 2006

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Alan P. Buckley. My office address is 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington 98504, and my e-mail address is abuckley@wutc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission as a Senior Policy Strategist. Among other duties, I am responsible for analyzing rate and power supply issues as they pertain to investor-owned utilities under the jurisdiction of the Commission.

Q. What are your education and experience qualifications?

A. I received a B.S. degree in Petroleum Engineering with Honors from the University of Texas at Austin in 1981. In 1987, I received a Masters of Business Administration degree in Finance from the University of California at Berkeley.

From 1981 through 1986, I was employed by Standard Oil of Ohio (now British Petroleum-America) in San Francisco as a Petroleum Engineer working on Alaskan North Slope exploration drilling and development projects. From 1987 to 1988, I was employed as a Rates Analyst at Pacific Gas and Electric Company in San Francisco. Beginning in late 1988 until late 1992, I was employed by R.W. Beck and Associates, an engineering and consulting firm in Seattle, Washington,

conducting cost-of-service and other rate studies, carrying out power supply studies, analyzing mergers, and analyzing rates the of Bonneville Power Administration and the Western Area Power Administration. I came to the WUTC in December 1993, where I have held a number of positions including Utility Analyst, Electric Program Manager and the position I presently hold. I have been a witness in numerous proceedings before the WUTC. I also have been a witness in proceedings at the Bonneville Power Administration and at the Federal Energy Regulatory Commission.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to present Staff's analysis and recommendations related to Avista's Petition for Continuation of the Company's Energy Recovery Mechanism, with Certain Modifications. I will address the testimony of Company witnesses Norwood, Cannell, Malquist, Peterson, Johnson, and McKenzie.

Q. How is your testimony organized?

A. I have organized my testimony into the following sections:

I. Introduction

II. Summary of Testimony and Staff's Recommendations

III. Continuation of the ERM

IV. Proposed Modifications to the ERM Net Power Cost Calculations

V. Proposed Modification to Eliminate the Deadband

VI. Future ERM Related General Rate Case Issues

Q. Are you sponsoring any exhibits with your testimony?

A. Yes. I am sponsoring Exhibit No.___ (APB-2) and Exhibit No.___ (APB-3).

II. SUMMARY OF TESTIMONY AND STAFF'S RECOMMENDATIONS

Q. Please describe the overall context for your analysis and recommendations in this proceeding.

A. Avista has filed a Petition proposing the continuation of the Company's Energy Recovery Mechanism with several structural modifications. The proposed modifications address both the methodology for calculating differences between actual and authorized net power costs as well as the sharing relationship between company and customers. The Company's Petition is in direct response to the Commission's Order No. 05 in Docket Nos. UE-050482 and UG-050483. In the Order, the Commission found that an adequate record did not exist on which to make a determination regarding certain changes to the ERM proposed as part of the Settlement Agreement filed under that docket. The Commission authorized and required Avista to make a subsequent filing to initiate a comprehensive inquiry into the Energy Recovery Mechanism. My testimony is Staff's response to that filing made by the Company.

Q. What were the primary issues identified by the Commission during its review of the proposed changes to the ERM in the Settlement Agreement?

A. The Commission identified proposed changes to the ERM's "deadband" feature and resulting balance of risk between the Company and its ratepayers, adjustments to the ERM's retail revenue credit calculation, and a dispute over what was identified as a "production property adjustment."

Q. Does the Company's Petition address additional ERM issues?

A. Yes. In addition to discussing the over-riding issue of whether the ERM should be continued or not, the Company is proposing to add transmission revenue and expense components to the ERM calculations. I will be addressing these issues in my testimony.

Q. Do you address additional issues as part of this comprehensive ERM review?

A. Yes. I will be addressing the need for "equality" among the different power cost recovery mechanisms that are before, or are expected to be before, this Commission. In addition, I briefly address the effect of ERM modifications on future general rate case issues.

Q. Did you participate in the Company's last general rate case or the development of the Settlement Agreement?

A. No.

Q. Are your recommendations in this proceeding constrained by the ERM-related conditions in the general rate case Settlement Agreement?

A. No. The settlement agreement reflected a compromise of positions, and the ERM-related provisions were part of a larger compromise. Our agreement with Avista explicitly provided that, if the Commission rejected our agreed result, we would not be bound by that agreement. Neither Avista nor the staff are required to support the ERM-related provisions of the settlement agreement, and in fact neither party is doing so.

Q. Please summarize your recommendations in this proceeding.

A. I am recommending that the Commission:

- continue to authorize Avista's use of the ERM. However, this recommendation falls short of an indefinite authorization for the ERM;
- accept the modifications to the ERM related to transmission revenues and expenses, and the calculation of the Retail Revenue Credit, with an additional modification;
- reject the Company's proposal to eliminate the dead band;
- modify the existing dead band such that, instead of bearing 100 percent of power cost variations up to $9 million, the company bears 50 percent of power cost variations up to $18 million; and
- order the Company to address the return and normalized net power supply issues identified by Staff in the next general rate case.

III. CONTINUATION OF THE ERM

Q. Should Avista's ERM be allowed to continue?

A. Yes. Although not specifically identified by the Commission, it is appropriate to address the issue of whether the ERM, or a power cost adjustment mechanism of any form, should continue for Avista as part of the overall comprehensive review.

Q. Did Avista address this threshold issue?

A. Yes. Although the Petition focuses on the elimination of the ERM's deadband feature, the Company states that the ERM is "an effective tracking mechanism" because it makes adjustments that allow the Company to recover its costs and ensure customers will not over- or under-pay as costs fluctuate. However, the Company appears to focus on the ERM as a tool for correcting the power costs in base rates that are not set "correctly." *(Exhibit No. ___ (KON-1T), at 6, lines 7 -12)*

Q. Do you agree with the Company's reasons for continuing the ERM?

A. No. While I support the continuation of the ERM, my reasons do not align with those of the Company. The rationale for continuing the ERM should not be as a tool for "correcting" the net power costs that are included in authorized base rates set by this Commission. If the base rates are not "correct," then Avista should address this by filing a general rate case. I believe the Commission sets rates that reflect an appropriate level of normalized net power supply costs and at a level that provides the Company with an opportunity to earn a fair return over time. The ERM should

not be in place, or designed, simply as a mechanism to adjust customer costs, irrespective of Commission general rate case orders. This concern is exacerbated by the Company's proposal to have no deadband as a feature of the ERM.

Q. Why are you then supporting the continuation of the ERM?

A. The ERM should be continued, with the sharing structure that I am recommending, because it will help Avista lower its cost of attracting investor capital and will improve incentives for Avista to manage its power supply costs. These results will benefit the customers of Avista. I believe that it is premature to end the Company's power cost adjustment mechanism experience. The ERM has been in place only for a relatively short period, much of that time influenced by the presence of significant, out-of-market priced gas contracts and historically low hydro-generation conditions. I encourage the Commission and other parties to support the basic principles of Avista's ERM for a period significant enough to evaluate its long-term effectiveness under a wide range of water and market conditions. However, it is clear that all parties also will benefit by treating the ERM as a "living" mechanism, making changes that reflect current conditions before both the Company and its customers. With this understanding, I am not proposing such a radical change to the existing balance between company and ratepayer risk as is proposed by Avista. I believe that the adjustments I am proposing to the ERM maintain the balance of risk necessary in an appropriately designed and flexible power cost adjustment mechanism.

Q. The Company is proposing that the existing ERM continue for an indefinite period of time, but without the deadband. Do you agree with this proposal?

A. No. Just as it is premature to end the ERM, it is also premature to commit to some indefinite period, with a deadband or without a deadband. I would propose that at some future date, no later than five years from now, the Commission should initiate an investigation reviewing the performance of all power cost adjustment mechanisms that have been in place by the regulated electric utilities.

Q. Do you believe that the Commission should reject any power cost adjustment mechanism that diverges from the Commission's 1989 policy guidance on such mechanisms?

A. No. While the general principles remain valid, I concur with the Company that the Commission's policy goals and guidelines from 1989 may be outdated by the environment the utilities operate in today.

Q. Please summarize these past policy goals and guidelines.

A. With respect to power cost adjustment mechanism the Commission has previously stated that: 1) a power cost adjustment clause should be linked to factors that are weather-related; 2) a power cost adjustment should be a short-run accounting procedure that reflects short-run cost changes affected by unusual weather; and 3) where a power cost adjustment mechanism is established, ratepayers should receive the benefit of a cost of capital reduction. (*See, e.g., WUTC v. Puget Sound Power & Light,* Docket Nos. U-89-2688-T, U-89-2955-P, Third Supplemental Order, at 13-15*;*

WUTC v. Washington Water Power, Docket No. U-88-2363-P, First Supplemental Order, at 8.)

Q. Should these policy goals and guidelines be revisited to address the conditions and circumstances that are present today?

A. Yes. Clearly, there are several factors that affect electric utility power costs which have changed since 1989. The most obvious of these are the increased levels and volatility in both wholesale electric and natural gas prices. Both wholesale electric prices and natural gas prices are now at levels several times what has been historically experienced and are expected to remain at these levels. These utility costs, largely not under the control of the Company, work in relationship with hydro-generation conditions to form the basis for actual net power supply expense costs that the Company experiences. I believe it is appropriate to include the effect of variability in these costs in a power cost adjustment mechanism designed for today's environment. In addition, modifications, such as the inclusion of transmission-related revenues and expenses, also serve to recognize both the benefits and costs of operating the Company's system.

Q. Do you believe the ERM addresses today's electric utility environment?

A. Yes. I believe the ERM is a reasonably straight-forward and easy to understand mechanism for calculating the variability of the Company's net power supply costs from the level set in base rates taking into consideration hydro conditions, wholesale energy prices, natural gas prices, and other factors.

Q. Do you believe that the continuation of the ERM or even its design should be affected by other power cost adjustments mechanisms adopted by this Commission?

A. Not at this time. I do not believe there is a single, effective design for power cost adjustment mechanisms. While some parties may advocate a goal to have similarly designed power cost adjustment mechanisms for all regulated electric utilities, I believe that the specific characteristics, circumstances and environment of each of the companies should guide power cost adjustment mechanism design. In fact, even when those factors are similar it may be in the best interest of all parties to purposely design and test different mechanisms, with perhaps an ultimate goal to develop a single power cost adjustment design.

IV. PROPOSED MODIFICATIONS TO THE ERM NET POWER COST CALCULATIONS

Q. Have you reviewed the Company's proposed modifications to the ERM?

A. Yes. I have reviewed the ERM modification related to transmission revenues and expenses as well as the modification related to the calculation of the Retail Revenue Credit.

Q. Do you support the Company's proposed modification to add transmission-related variable revenues and expenses to the ERM?

A. Yes. The transmission assets of the Company should be considered resources that are available to provide benefits to ratepayers. The Company has identified potential revenue from third-party wheeling transactions using Avista's system and from transmission service provided to various BPA borderline customers using the system. *(Exhibit No.___ (WGJ-1T), at 4, lines 9-20)* The revenues may not be captured when determining the normalized net power supply expense used to set base rates. Correspondingly, there may be variable transmission-related expenses related to wheeling economically dispatched Colstrip and Coyote Springs 2 power into Avista's system, as well as wheeling expenses associated with various short-term sales or purchases, small power purchases, and providing service to Avista customers that are interconnected with BPA or other transmission systems. I believe the additional revenues or expenses associated these transactions should be captured in the ERM as a part of determining actual net power supply costs.

Q. Is this consistent with the manner in which transmission-related revenues and expenses have been addressed in setting normalized net power cost for base rates?

A. Yes. Historically, some level of transmission revenues and expenses has been included in the determination of the normalized net power supply expenses when setting base rates. Tracking the variability of these transmission-related revenues

and expenses and including them in the ERM only serves to recognize their value as part of the overall management of Company resources.

Q. Do you support the Company's modification for determining the Retail Revenue Credit?

A. Yes. The Company is now proposing to exclude allocated common costs from the retail revenue credit rate. This is a deviation from the original methodology that allocated common general costs to production, transmission and distribution functions, thus affecting the Retail Revenue Credit rate. However, in the most recent general rate proceeding, common general costs were maintained as a separate function in the cost of service model and were, therefore, not included in the calculation of the Retail Revenue Credit rate. The intent of the ERM is to capture changes in net power supply costs associated with providing power to customers, not changes associated with the common general cost function.

Q. Do you recommend any other changes to the Retail Revenue Credit determination?

A. Yes. If the Commission accepts Avista's proposal to include transmission revenues and costs in the ERM calculations, then it is appropriate to adjust the Retail Revenue Credit rate to include a transmission component, to address the recovery of those costs when loads vary from authorized levels.

Q. What should the Retail Revenue Credit rate be adjusted to?

A. Based on the company's cost of service model run identifying the production credit rate of $0.03289, the transmission component is $0.00614, which should be added to create a total Retail Revenue Credit rate of $0.03903.

Q. Are you proposing any additional modifications related to the calculation of net power supply costs in the ERM?

A. No.

Q. The Company has summarized the procedures relating to the annual ERM filing to review deferrals. Are you proposing any changes to this procedure as part of this comprehensive review of the ERM?

A. No. I believe the annual process in place continues to provide ample opportunity for the review of ERM parameters and results. The monthly ERM reports also continue to facilitate the annual review process, including the effects of new purchase power contracts entered into by the Company.

Q. What is your recommendation regarding the use of a "production property adjustment," identified by the Commission in the Order in Docket No. UE-050482 and addressed by the Company in its Petition?

A. It is not necessary to incorporate a "production property adjustment" into the ERM. I support the continued use of the Retail Revenue Credit adjustment that is presently part of the ERM. The Retail Revenue Credit is simple to understand and a

straightforward tool to adjust net power costs, offsetting the change in power supply costs due to actual retail load requirements. This adjustment prevents the over- or under-recovery of fixed costs due to the departure of actual retail loads from what was used to determine base rates. As described by the Company, the difference between actual and authorized power supply costs tracked by the ERM is reduced by the fixed cost component of production-related costs if actual loads are greater than what was used to determine base rates. Correspondingly, any differences are increased when actual loads are less. This adjustment maintains a reasonable alignment between the actual and authorized power supply costs that are addressed in the ERM.

V. PROPOSED MODIFICATION TO ELIMINATE THE DEADBAND

Q. Avista is proposing to eliminate the "deadband" feature of the ERM. Have you reviewed the Company's testimony supporting its Petition, and are you supporting this modification?

A. Yes, I have reviewed the testimony, and, no, I do not support the modification. In its place, I am proposing an alternative modification that addresses my concerns and goals discussed below.

Q. What is the Company's basis for proposing to eliminate the "deadband" feature of the ERM?

A. The Company is basing its recommendation on several factors: 1) the desire of investors to have predictable earnings; 2) the goal of the Company to regain an investment-grade credit rating; and 3) the apparent belief that the "deadband" is forcing the Company to absorb large amounts of power costs.

Q. Please comment on the first factor: the desire of investors to have predictable earnings.

A. There should be no dispute that investors prefer predictable earnings over unpredictable earnings; that fact is reflected in the higher rate of return paid to equity investors compared to debt investors. Similarly, there is no dispute about the fact that the company's earnings would be more stable without the deadband. Company witness Cannell discusses the perspective of investors with respect to the ERM and the proposed elimination of the deadband. After much discussion, the conclusion is reached that investors believe the deadband prolongs the timeframe for the Company to reach an investment-grade credit rating and that uncertainty associated with volatility makes Avista a riskier investment. The fact that investors look for stability in earning and dividends is certainly desirable, as is the desire for the Company to return to investor-grade credit. Given the emphasis of the witness, none of these conclusions is surprising; of course, removal of the deadband would increase the predictability and decrease the volatility of Avista's earnings. I am not going to attempt to rebut these conclusions, except to note that Ms. Cannell makes no attempt

to quantify the effect of retaining the deadband or a portion of the deadband. In addition, nowhere in Ms. Cannell's testimony are the words: "ratepayers," "customers," "incentives," or "balances between risks and returns" discussed, or even mentioned for that matter. Nor does Ms. Cannell discuss any issues associated with the implementation of the ERM and how, and why, the deadband was initially established. I will address these issues later in my testimony.

Q. Please comment on the second factor: the goal of the Company to regain an investment-grade credit rating.

A. Once again, the Company witness makes the rather obvious conclusion that the ERM improves the timing and stability of cash flow and earnings and that the $9 million deadband "undermines the Company's ability to recover its costs and thus reduce its debt, reduce its interest expenses, and return the Company to investment grade." *(Exhibit No.__ (MKM-1T), at 4, lines 3 - 9)* Mr. Malquist describes how the Company's financial position results in a BB range for two financial ratio benchmarks and actually falls below BB for another. I do not disagree that the $9 million deadband has some effect on Avista Corporation earnings volatility. However, that effect is not as important as other factors affecting the Company's earnings and thus volatility. Mr. Malquist has also failed to show that the elimination of the deadband will result in raising the financial indices to investment grade. Finally, once again, nowhere in Mr. Malquist's testimony are "ratepayers," "customers," "incentives," "risk sharing," or "balances between risks and returns" discussed, with Mr. Malquist stating only that lower interest rates from better credit

ratings would reduce potential rate pressure in the long term, but with no quantification.

Q. Does Mr. Malquist's analysis appropriately capture the financial effects of the present $9 million deadband?

A. No. Mr. Malquist's analysis of financial ratios demonstrating the relatively unfavorable credit ratings is for Avista Corporation, not Avista Utilities. *(Exhibit No. ___ (MKM-1T), at 10, Table 1).* For example, Table 1 shows a coverage ratio of 2.3(x), a value that is adversely affected by the lack of earnings from the unregulated activities of Avista Corporation. Table 1 also shows a relatively poor 59.9 percent "Total debt/total capital" ratio, which is affected by approximately $238 million of book equity related to investment in regulated activities.

Q. Can you quantify the impact of the $9 million dollar deadband based on Avista Corporation?

A. Yes. The effect of the $9 million deadband represents an impact on Avista Corporation earnings of plus or minus $0.12 per share. This is based on a net operating income impact of $5.85 million and 48.5 million shares outstanding. This compares to earnings of $1.66 based on Avista Corporation's book value of $15.89 per share and earning 10.5 percent (assuming the non-regulated activities earn the utilities overall return). If the Company absorbs $9 million of increased net power costs, earnings would decrease to $1.54, or 9.7 percent earnings on book. On the other hand, if the Company gains $9 million from decreased net power costs, the

earnings would increase to $1.78, or an 11.3 percent earnings on book. The information used to calculated these impacts is contained in the Company's 2005 Form 10-k, excerpts of which are provided in Exhibit No.___ (APB-2).

Q. What do Avista's Financial Statements show regarding the $ 9 million deadband?

A. The $9 million deadband has a relatively small effect on Avista Corporation's earning variability. For example, in 2005 the $0.12 per share effect of the band lowered earnings of Avista Utilities to 10.22 percent from what would have been 11.02 percent, had the deadband not been in place.

Q. What is the impact of Avista Corporation's unregulated activities on the Corporation's financial results?

A. In 2005, Avista Corporation's ROE was only 5.85 percent, principally the result of losses in unregulated activities. These financial results form the basis for Mr. Malquist's Table 1 on page 10 of his testimony, showing the unfavorable financial ratio benchmarks.

Q. What conclusions can you make from the Company's financial statements?

A. The unregulated activities of Avista Corporation has a much greater effect on earning variability than does the deadband feature of the ERM.

Q. The Company describes its near term capital requirements and the refinancing of debt. Is the effect of the $9 million deadband quantified in any manner in that discussion?

A. No. Mr. Malquist states only that the Company has a need for capital expenditures and that, "Issuance of securities depends upon the Company maintaining a strong capital structure, sufficient interest coverage, and investment-grade credit ratings to be able to access capital at reasonable costs." *(Exhibit No.___(MKM-1T, at 13, lines 16-19)* Regarding the need for capital expenditures, the Company's financial statements indicate an availability of over $128 million generated from internal operations.

Q. The third factor that the Company uses to support the elimination of the deadband relates to actual net power costs that have been "absorbed" since the ERMs inception. Do you care to comment on these claims?

A. Yes. Mr. Malquist does indeed opine that the Company has been "required" to expense in excess of $9 million for several years and that approximately $37 million has been absorbed by the Company since the inception of the ERM. Mr. Malquist does not mention the $51.8 million (2002, $15 million; 2003, $22.2 million; 2004, $10.5 million; and 2005, $4.1 million (pending)) amount of deferral for ratepayer recovery since 2002, or the additional $196 million of excess power costs assigned to ratepayers prior to the beginning of the ERM and that have been included for recovery from ratepayers through the Company's deferral mechanism. Mr. Malquist also neglects to discuss the "flip" side of the deadband, that is, ability of the

Company to benefit from the ERM's $9 million deadband in the long term, as water conditions rebound from several years of extreme drought. The Company appears to assume the worse, that it will be always absorbing $9 million if the deadband is not eliminated.

Q. You have stated several times that the Company has not provided adequate quantification of the effects of the deadband on its financial positions. Given the variability in water conditions, wholesale electric prices, and natural gas prices, what analysis would you have expected the Company to undertake?

A. I would have expected the Company to model Company earnings and financial statements – given a number of possible water conditions, wholesale electric prices, and natural gas price scenarios – in order to provide a better understanding of the combined variability in these financial parameters. No such studies were provided in support of the Company's Petition and the proposal to eliminate the deadband entirely.

Q. Please describe your understanding of the long term effects of the deadband on Company cash flow and earnings.

A. Over the long term – *e.g.*, a period of normal variations in water conditions – the ERM should allow the Company a reasonable opportunity to recover additional revenues to balance the amounts absorbed in less favorable water years. However, this design feature is influenced by the level of net power supply costs that are used to determine authorized base rates and the basic assumptions of wholesale electric

market prices and natural gas prices in the general rate case. It is my understanding that both of these pricing assumptions were significantly updated in the last general rate case as compared to previous levels.

Q. Please describe the possible short-term effects of the deadband during 2006.

A. It appears that 2006 may be a more favorable water year than the region has experienced over the past few years. Therefore, the ERM's deadband feature has the potential for returning earnings to the Company, once the annual review is completed.

Q. Do you believe there are specific reasons that the Company has absorbed $37 million since the inception of the ERM?

A. Yes. I believe is important to look at some of the history of the ERM to understand the recent effects of the deadband, not just to add up the numbers. The ERM was established subsequent to the 2000-2001 Western energy crisis, at a time when Avista had several power supply-related problems. The Company was experiencing a perfect storm of residual effects of the energy crisis: severe drought conditions, extended outages at newly acquired resources, and the need for financing. Although the ERM was established as part of a settlement, I believe the parties would agree that it was anticipated that the actual net power costs would be significantly over the deadband for the first few years of the ERM, primarily the result of natural gas contracts that were not needed because of extended outages and were significantly priced out-of-market. The ERM provided a mechanism for the Company to absorb

costs, at the same time telling the investment community that a mechanism was in place to potentially recover costs, in the event water conditions and markets turned around. The ERM helped ease the financial stress of the perfect storm as well as the results of potential prudence investigations related to the natural-gas transactions and extended generation outages.

Immediate benefits to ratepayers were not so clear. While it was anticipated that the Company would absorb the deadband amount, set primarily to address the out-of-market natural gas contract issue, ratepayers would be immediately at risk, under the 90 percent sharing feature, for any increased power supply costs due to continued poor water conditions and high wholesale market prices. This was demonstrated by the significant deferrals assigned to ratepayers in the early years of the ERM. True risk sharing from a base level would take place only after the out-of-market natural gas issue was eliminated as the contracts expired and base rates were established with the latest estimates of market parameters. The year 2005 went part of that distance and 2006 should go the rest as new base rate net power costs were established in the general rate case.

Q. Should these reasons affect the decision to keep or eliminate the deadband at this time?

A. No. The analysis of proposed modifications to the ERM should be forward-looking. However, I did not want the Commission to be left with the impression that only the Company has been asked to absorb significant risk over the life of the ERM.

Q. You earlier mentioned incentives, risk sharing and the balance between risk and returns. Can you comment on those issues in context of the Company's proposed elimination of the ERM's deadband?

A. I believe that maintaining incentives are an important feature in a power cost adjustment mechanism. Clearly, the $9 million deadband provides incentives for the Company to manage its resources and power transactions in a least cost manner, at least up to the point of the deadband level. However, the incentive of a 90 percent ratepayer and 10 percent Company sharing mechanism after the deadband differential is reached is less obvious. Under the presently designed ERM, the risk-sharing aspect is different for the Company and the ratepayer. The Company is at total risk for the smaller but more probable range of net power cost variations under the deadband, while ratepayers are at risk for the greater majority of costs over the deadband amount. The removal of the deadband places virtually all (90 percent) of the risks in net power cost variations on ratepayers. Finally, the Company has not quantified the effect on authorized returns that is appropriate as a result of eliminating the deadband. Clearly, a removal of the deadband shifts significant risk away from the Company and should be reflected when determining the appropriate return in the general rate case.

Q. Has the Commission provided guidance regarding the deadband feature in power cost adjustment mechanisms?

A. Yes. Most recently, in its Order No. 04 in *WUTC v, PacifiCorp d/b/a Pacific Power & Light Co,* Docket No. UE-050684 (April 17, 2006), the Commission states that:

"Deadbands and sharing bands are useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs" *(Order at ¶ 96)*, and that: "The 90/10 sharing band and the absence of a deadband do not adequately balance risks and benefits between shareholders and ratepayers." *(Order at ¶ 99)* Based on this guidance alone, the Company's proposal in this proceeding should be denied.

Q. Are there other ways to address some of the Company's goals other than the removal of the deadband?

A. Yes. It appears that improving the earnings of Avista Corporation's unregulated activities would go a long way toward meeting many of the Company's goals. From the utilities perspective, the Company could explore the use of hedges, or fixed price contracts, for natural gas used in generation for its base load requirements as a tool to decrease volatility in earnings, rather than necessarily minimize net power costs, if corresponding benefits from the financial community would occur.

Q. Are you proposing any modifications to the ERM's deadband as part of this comprehensive ERM review?

A. Yes. In the spirit of recognizing the ERM as a "living" mechanism that changes as conditions change, Staff is prepared to convert the $9 million dollar deadband into a 50/50 sharing mechanism over a broader range of power cost variations. However, in order to maintain the present risk sharing balance in the event of more extreme water conditions, I propose that the 50/50 sharing of net power cost differentials

between the Company and customer remain until a plus or minus $18 million differential ("initial sharing band") is reached. At that time, the present 90/10 sharing would occur. This actually results in slightly less exposure to the Company and slightly more benefit to customers in the event that net power costs are significantly higher or lower than authorized levels, respectively. (For example, under the present deadband the Company would absorb $13.1 million of a $50 million increase – $9 million plus 10 percent of $41 million, but would absorb $12.2 million under Staff's proposal – $18 million times 50 percent or $9 million, plus 10 percent of $32 million.)

Q. What does the $18 million initial sharing band represent?

A. The $18 million initial sharing band represents the same level of exposure to net power cost variations to the Company as the current $9 million deadband. This is appropriate in order to maintain some consistency between the future risk profile and the existing risk profile that has been previously accepted by the parties. In addition, the $18 million level is also equal to the Company estimates of the effects, plus and minus, on net power costs of a 10-percent variation in hydro generation.

Q. Why are you proposing that a 50/50 sharing band replace the present deadband?

A. This change should ultimately benefit customers in two ways, by lowering the cost of capital for Avista and by increasing Avista's incentives to manage its power costs. Reducing the company's share of variations in power supply costs will reduce the

company's financial risk. With more stable earnings, the company should be able to finance itself with a higher bond rating and a lower cost capital structure. The Commission should require a commitment from the company that it will actually lower its capital costs to reflect the change in the ERM. However, I also believe the Commission should continue to maintain a level of balance between Company and ratepayer risks and benefits. The 50/50 sharing proposal will reduce variability in Company earnings (as compared to the present deadband approach), yet provide the necessary incentives for the Company to manage its resources and power supply transactions in a prudent manner. I believe the elimination of the deadband, without the 50/50 sharing, does not provide sufficient incentives. The risk-sharing aspect of the ERM is more symmetrical under a 50/50 sharing mechanism. Both the Company and ratepayers share equally in the risk associated with a plus or minus $18 million variations in net power costs. However, this proposal maintains the ratepayers risk associated with larger, more extreme variations in power costs. Thus, the 50/50 sharing proposal provides an appropriate level of exposure to power cost variations for ratepayers, between the level of risk that was inherent in the traditional normalized net power cost methodology without a power cost adjustment, and the virtual total risk (90 percent) of the Company's proposed no deadband approach.

Q. How do your proposed changes to the sharing mechanism affect Avista's incentives to operate efficiently?

A. The effects are mixed, but overall I believe the changes will improve the company's incentives. The company's incentives are strongest when it expects to bear the full

effect of any cost increase or decrease. Therefore, if the company expects the power cost differential to be within plus or minus $9 million, the current mechanism provides a strong incentive for efficiency because the company bears the entire amount of the differential. However, if the company expects the differential to be outside the range of plus or minus $9 million, then its incentives are much weaker, because at the margin it would retain only 10 percent of any savings or pay only 10 percent of any excess cost. The proposal to use 50/50 sharing reduces the company's incentives within the $9 million band and increases the company's incentives outside that range, at least up to the $18 million point.

Q. Are there other benefits to your 50/50 sharing proposal?

A. Yes. Replacing the deadband with the 50/50 sharing better aligns the parties' interests in general rate cases with respect to setting the level of normalized net power costs in base rates.

Q. What is the effect on Avista Corporation earnings of your 50/50 sharing proposal?

A. As I stated earlier, the 50/50 sharing proposal should decrease the variability in earnings for the Company. The impact on earnings ($0.12 per share plus or minus) equivalent to the $9 million deadband would not be reached until the differential in net power costs reached $18 million. Given the normal distribution of water condition frequency, it should be expected that the $18 million in net power cost differential is reached less often than the $9 million level of the present deadband. In

fact, at the $9 million dollar differential net power cost level, the impact on earnings is half, or $0.06 per share plus or minus.

Q. Have you prepared an exhibit showing the effects of the various ERM risk-sharing proposals?

A. Yes. Exhibit No.___ (APB-3), page 1, shows the risk-sharing profile of the present deadband mechanism. Customers' exposure to the risk and benefits of net power cost variability is indicated by the lighter shaded area. The Company's exposure is indicated by the darker-shaded area. Under the present deadband mechanism, the risk and benefits to customers do not begin accruing until the $9 million level is reached, when customers absorb 90 percent of the risk and get 90 percent of the benefits. Exhibit No.___ (APB-3), page 2, shows the risk-sharing profile of the Company's proposal to eliminate the deadband. This proposal results in customers being exposed to a much greater share of the risks and benefits of net power cost variations, while the Company's exposure is limited to 10 percent. Exhibit No.___ (APB-3), page 3, shows Staff's proposal in this proceeding. Customer and Company exposure is aligned until $18 million variance in net power costs is reached, at which point customers are exposed to 90 percent of the risks and benefits.

VI. FUTURE ERM-RELATED GENERAL RATE CASE ISSUES

Q. Are there additional ERM related issues that should be addressed in the Company's next general rate case?

A. Yes. I believe that there are three ERM-related issues that are more appropriately addressed in the Company's next general case. The first issue relates to the alignment of Avista's cost of capital with the ultimate design of a modified ERM, if approved. The Company's direct case in its next general rate case should address the decreased variability in Avista Utilities earnings resulting from any approved proposal that varies from the present $9 million deadband mechanism. The effect of any ERM design and the impacts of the mechanism on cost of capital must be fully addressed by the Company for imposing additional risks absorbed by the ratepayers.

The second issue relates to the levels and pricing of natural gas acquisitions used in determining net power costs when setting base rates in a general rate case. As I discussed earlier, the Company can take a more aggressive approach to minimizing earnings variability by fixing or hedging gas prices for base load generation from its gas-fired generating facilities, particularly Coyote Springs. Such a strategy may vary from the present hedging strategy, but may provide additional benefits through the investment community. The benefits and costs of potential changes in hedging strategy should be addressed in the next general rate case.

Finally, I believe that the Company should address the relationship between power cost adjustment mechanisms and the use of the normalized net power cost

methodology in setting base rates. The normalized net power cost methodology has been the traditional method for addressing the water year (and thus net power cost) variability for Pacific Northwest utilities. This method bases net power costs on the expected value of a number of water year conditions, including the resultant effects of wholesale electricity markets and natural gas prices. However, one of the long standing issues associated with this method has been the relationship between extreme water condition years (good and bad) and wholesale electric and natural gas prices. There is more uncertainty in these net power cost components in the extreme years, which then results in more uncertainty in the level of base rates that are set. In addition, parties have battled for years over what water years should be used to calculate normalized net power expenses: 40, 50, 60, or more – all in attempts to bias or not bias base rate results. I believe that all of this effort may be unnecessary and counter-productive in a state regulatory environment where power cost mechanisms are in place, particularly when power cost mechanisms incorporate no deadband or an initial sharing band such as proposed in this proceeding by the Company and Staff. The focus and energy of the parties can best be directed toward determining a reasonable level of net power costs based on a reasonable sampling of average water years or even a single "typical" year. The power cost adjustment mechanism (such as the ERM), designed with this in consideration, is then used to share the risks of water and other variations of power cost parameters between ratepayers and the companies. Issues that Staff has attempted to address in the past, such as the over or under recovery of power costs, would be eliminated. Therefore, I

believe the Company should take the ultimate approved design of the ERM in this proceeding into consideration when developing its next general rate case.

Q. Does this complete your testimony?

A. Yes.