BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES Respondent.	DOCKET NOS. UE-050482 UG-050483

BRIEF OF COMMISSION STAFF

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I. INTRODUCTION

1 The Commission has before it a comprehensive multi-party settlement of Avista Corporation's (Avista or the Company) general rate case filing. After performing an extensive review of Avista's books, records, accounts, testimony, and evidence in this proceeding, Commission Staff (Staff) was able to reach a settlement with the Company that produces fair, just, reasonable, and sufficient rates. The Energy Project, representing low-income ratepayers, and the Northwest Industrial Gas Users (NWIGU) have joined Staff in the Settlement Agreement. The Public Counsel Section of the Attorney General's Office (Public Counsel) and the Industrial Customers of Northwest Utilities (ICNU) oppose the settlement.

2 The Settlement Agreement represents a compromise among many differing points of view. Concessions were made by all of the signing parties to reach a reasonable balancing of interests. The end product results in significantly lower increases to Avista's electric and gas rates than was requested in either the Company's original or revised filing. The Settlement Agreement also includes an equity-building mechanism that will require Avista to increase its utility equity component over the next three years or be subject to automatic reductions in base utility rates; modifications to the Company's Energy Recovery Mechanism (ERM); and commitments by Avista to increase funding levels for two existing programs whose purpose is to assist limited-income customers. Because the Settlement

Agreement results in rates that are fair, just, reasonable, and sufficient, Staff recommends that it be approved by the Commission.

II. BACKGROUND

A. Procedural History

3 On March 30, 2005, Avista filed proposed tariff revisions requesting that the Commission grant an electric rate increase of $35,833,000 annually, or 12.5% in base retail rates. The Company also requested that the Commission grant a rate increase of $2,943,000 annually, or 1.7%, for its natural gas operations. Avista's request was based on a proposed rate of return of 9.67%, with a common equity ratio of 44% and an 11.5% return on equity. Ex. 1 at 4. Avista later revised its electric rate increase request downward to $33,433,000, and revised its natural gas rate increase request downward to $2,564,000. Ex. 11 at 5.

4 Avista proposed to spread the electric rate increase by rate schedule so that the relative rates of return for the individual rate schedules would move one-third toward unity. The Company proposed to raise the electric residential basic charge to $5.50, up fifty cents from the current $5.00 charge. Avista proposed a natural gas rate increase that would move the rates of return for each rate schedule to within 5% of the cost of service study results (5% of unity). *Id.*

5 Staff reviewed Avista's rate case filing extensively from April through July 2005. Six primary Staff members were assigned to this case, with varying roles of

responsibility. Staff propounded a total of 165 data requests, and performed several on-site visits to Avista covering all aspects of the case. Staff devoted significant time and energy to understanding the issues, auditing the books and records of the Company, and examining every accounting adjustment proposed by Avista in its rate filing. The Staff members involved with the Company's power supply model (AURORA) had formal training with the model's vendor and Avista in the use of the model. Furthermore, Staff reviewed the responses to data requests submitted by other parties to the case. (Avista responded to a total 570 data requests in this docket). Ex. 1 at 6-7; Ex. 4 at 1.

6 The Commission's prehearing conference order, issued in May 2005, expressly provided for settlement conferences to be held at the end of July 2005, one month before the due date for responsive testimony to Avista's general rate case filing. Consistent with this schedule, Staff and the other parties to this case engaged in several settlement meetings in late July and early August 2005. The parties engaged in the "give-and-take" that characterizes settlement discussions and attempted to arrive at a reasonable balancing of differing interests. Each of the signing parties agreed to concessions on matters that would not have been agreed to if each of the signing parties were to proceed to evidentiary hearings. Ex. 1 at 6.

7 Staff, for its part, clearly understood that, were this case to proceed to litigation, Avista would be advocating for a much higher revenue requirement than

it was willing to offer in settlement negotiations, and concluded that, given Staff's assessment of the merits of the positions of all parties, settlement on the basis proposed in the Settlement Agreement is appropriate and in the public interest. Ex. 4 at 2. At the hearing, Mr. Braden succinctly summarized the role of the Staff in a general rate case in this regard:

> I think our role is to scrutinize the filing for accuracy, for compliance with law and Commission orders, and also to in essence look out for the interests of all parties involved in the proceeding, that is those who are consumers of the product and those who provide the product, the rate payers and the company, because our mandate is fair, just, reasonable, and sufficient [rates], which includes all aspects of that spectrum.

Tr. at 279-280.

8 The parties arrived at a settlement that provides for a revenue requirement that is significantly reduced from the Company's original and revised filings, as well as including several other favorable elements. Staff concluded that the Settlement Agreement in this case represents a just, fair and reasonable compromise of the competing interests presented in this case when they are considered as a whole.

9 NWIGU and the Energy Project are also signing parties to the Settlement Agreement. Public Counsel and ICNU are the only parties which have filed testimony opposing the settlement.

B. The Settlement Agreement

10 On August 12, 2005, Avista, Staff, the Energy Project and NWIGU submitted the proposed multi-party settlement agreement to the Commission. The Agreement was later modified slightly, to provide for an effective date of January 1, 2006. *See* Ex. 2 and 3. The Settlement Agreement provides for an annual electric rate increase of $22.1 million, representing an $11.3 million decrease from the Company's revised $33.4 million request. The Settlement Agreement provides for an annual natural gas rate increase of $968,000, representing a $1.6 million decrease from the Company's revised $2.6 million request.

11 The Settlement Agreement calls for an overall rate of return of 9.11%, with a common equity ratio of 40% and a 10.4% return on equity. In addition, the agreement provides an equity building mechanism that requires Avista to increase its actual utility equity component to 35% by December 31, 2007, and to 38% by December 31, 2008. Should the Company not meet either of these targets, the Company will be required to implement a 1% reduction in base utility rates (or 2% if neither is met), spread uniformly across all classes. If the Settlement Agreement is approved, Avista further commits that it will not seek to increase its natural gas rates again prior to July 1, 2007, absent a showing of extraordinary circumstances.

12 The Settlement Agreement also includes approximately twenty adjustments to the electric and natural gas revenue requirements. Tr. 151-52. These adjustments were the product of negotiation and compromise.

13 The Settlement Agreement makes two changes to Avista's existing Energy Recovery Mechanism (ERM). The ERM is a mechanism for adjusting power supply-related costs. It arose due to a prior Commission order stemming from the 2000-01 Western energy crisis. Tr. at 152. The first change contained in the settlement is to reduce the "deadband" associated with the ERM from $9 million to $3 million, effective January 1, 2006. Ex. 1 at 25; Ex. 3 at 2, Section 13(A). The deadband is a portion of the ERM which provides that the Company absorbs all impacts, both positive and negative, within a set point that is determined by power supply cost base line. Tr. at 153. In its original general rate filing, Avista had requested that the deadband be eliminated entirely; the Settlement Agreement, arrived at through negotiations, represents a compromise of that position. *Id.*

14 The second change proposed is to increase the surcharge associated with the ERM by about 10% over current levels, increasing revenues by approximately $2.7 million annually. The surcharge is a special portion of Avista's rates that is dedicated exclusively for repayment of the existing ERM deferral balance, which is currently about $100 million. Tr. at 153-54. Recovery of the deferral balance in a

timelier manner will allow the Company to buy back more debt, build the utility's equity component, and improve its financial health more quickly. Ex. 1 at 28.

15 Other ideas and proposals were discussed in the course of settlement negotiations about the ERM, some of which appear to Staff to have merit and should be looked into more fully. Tr. at 154. The Settlement Agreement, accordingly, provides that the Company will initiate discussions among all interested stakeholders concerning possible changes to the ERM prior to December 31, 2005. Ex. 2 at 5, Section 13(C).

16 The Settlement Agreement also includes low-income and demand-side management program (DSM) enhancements. Specifically, under the settlement the Company will provide an additional $600,000 per year for two years to the Low Income Rate Assistance Program (LIRAP); the Company will also provide an additional $200,000 per year to fund low-income DSM. Ex. 1 at 28, Ex. 2 at 6-7, Section 15(B). A number of other program enhancements and operational changes will allow more flexibility in the use of these funds in the administration of these programs. Tr. at 155; Ex. 2 at 7, Section 15 (C).

17 The Settlement Agreement contains some relatively minor shifts from the initial company proposal with regard to rate spread, generally moving toward parity; that is, the concept that customers essentially pay an amount equivalent to

the cost a providing them service among the various classes. Tr. at 155; Ex. 2 at 5-6, Section 14.

18 Finally, the Settlement Agreement includes the financial impact of Avista's purchase of the second half of the Coyote Springs 2 ("CS2") plant. As the joint testimony indicates, Staff has investigated and analyzed this matter, and has determined that this resource acquisition was prudent. The settling parties, therefore, have requested that the Commission, in approving the Settlement Agreement, include a specific finding that CS2 was prudently acquired. Ex. 1 at 21-25.

19 The Settlement Agreement, as indicated above, was a product of negotiation and compromise. For this reason, it includes the following clause:

> By executing this Settlement Agreement, no signing party shall be deemed to have accepted or consented to the facts, principles, methods, or theories employed in arriving at the Settlement Agreement, and except to the extent expressly set forth in the Settlement Agreement no Signing Party shall be deemed to have agreed that such a Settlement Agreement is appropriate for resolving any issues in any other proceeding.

20 Staff witness Mr. Braden further accurately and succinctly summarized the nature of the Settlement Agreement as follows:

> Finally, let me just say that this was a settlement as a result of an extensive and I think very productive and open settlement discussion process that took place over many days, both in person and through exchanges of data and other communications. As in all settlements, it's not perfect; it doesn't represent any individual party's ideal position. It is a compromise. It's not based on mathematical

> formulas. It's a matter where there are certain offsets that occur in the course of negotiation. But Staff and all the parties who have signed the settlement agreement and submitted joint testimony believe that the compromises reached are fair, just, reasonable, and sufficient under the circumstances, and we support the settlement and urge the Commission's subsequent approval.

Tr. at 155-56.

21 Public Counsel and ICNU have filed testimony in opposition to the Settlement Agreement. Public Counsel's direct testimony recommended an electric rate increase of $11.7 million and a natural gas rate increase of $218,000. Ex. 232, p. 1; Ex. 233, p. 1. Public Counsel later revised these figures in its rebuttal testimony and it now recommends an electric rate increase of $6.4 million, and a natural gas rate decrease of $114,000. Ex. 236, p. 1; Ex 237, p. 1. ICNU has made a number of recommended power supply adjustments totaling $14.4 million (Ex. 301, p. 4), but does not provide an overall electric or natural gas revenue recommendation.

III. ARGUMENT

A. The issue in this case is whether the Settlement Agreement should be approved because it is lawful, supported by an appropriate record and in the public interest.

22 Both the Administrative Procedure Act (APA) and the Commission's rules encourage and support settlements. RCW 34.05.060; WAC 480-07-700. The APA, furthermore, authorizes agencies to "establish by rule specific procedures for attempting and executing informal settlement of matters." RCW 34.05.060. The Commission has implemented such rules. Under WAC 480-07-750(1):

> The commission may decide whether or not to consider a proposed settlement. The commission will approve settlements when doing so is lawful, the settlement terms are supported by an appropriate record, and when the result is consistent with the public interest in light of all the information available to the commission.

23 The Commission anticipates that some settlements will be "full settlements," which reflect an agreement by all of the parties to resolve all of the issues in a case, while other settlements, such as the present one, will be "multiparty settlements," which reflect an agreement of some, but not all, parties. WAC 480-07-730 (1), (3). Where there is a multiparty settlement, the opponents of the proposed settlement retain substantial rights, all of which have been observed by the Commission here: the right to cross-examine witnesses supporting the proposal, the right to present evidence and argument opposing the proposal, and the right to present evidence in support of the opposing parties' preferred result. WAC 480-07-740(2) (c).

24 Nevertheless, the issue at this stage of the proceeding is the lawfulness of the proposed settlement that is before the Commission, and whether it is consistent with the public interest. Evidence that has been admitted by both supporting and opposing parties is relevant to the extent it addresses this issue. Under the Commission's rules, the Commission may approve the settlement, accept the settlement with conditions, or reject the settlement. If the Commission rejects the settlement (or imposes conditions that are not accepted by the settling parties), then "the litigation returns to the status at the time the settlement was offered." WAC

480-07-750. Staff submits that the Settlement is lawful, supported by an appropriate record, and in the public interest, and therefore, should be approved.

B. The Settlement Agreement results in an overall revenue requirement and rates that are fair, just, reasonable, and sufficient, and therefore is in the public interest.

25 RCW 80.28.010 requires that electric and natural gas rates be "fair, just, reasonable, and sufficient." RCW 80.28.020 states that the Commission shall not set rates that are "unfair, discriminatory, unduly prejudicial, or insufficient to yield reasonable compensation." These goals require that the Commission consider both the interests of the ratepayers and the Company. The Washington Supreme Court has held that:

> [T]he WUTC must in each rate case endeavor not only to assure fair process and service to customers, but also to assure that regulated utilities earn enough to remain in business—each of which function is as important in the eyes of the law as the other.

People's Organization for Washington Energy Resources v. Utility & Transp. Comm'n, 104 Wn.2d 798, 808, 711 P.2d 319 (1985)(*citing State ex rel. Puget Sound Power & Light Co. v. Dep't of Pub. Works,* 179 Wash. 461, 466, 38 P.2d 350 (1935).

26 The Commission, in a prior case also involving Avista, also has recognized the need to balance ratepayer and company interests:

> We regulate [utilities] to ensure that rates charged to customers are fair, just, and reasonable, and that those rates are sufficient for the utility to maintain financial viability and the capability to fulfill its obligation. The public interest is served when the interests of the

> utility and the interests of the utility's customers are kept in careful balance[.]

In re the Matter of Avista Corp., d/b/a Avista Utilities Request Regarding the Recovery of Power Costs Through the Deferral Mechanism, Docket No. UE-010395, Sixth Supplemental Order, ¶ 7 (Sept. 24, 2001).

27 The Settlement Agreement here appropriately balances ratepayer and company interests to arrive at an overall revenue requirement and rates that are fair, just, reasonable, and sufficient. In this regard, it is similar to another recent case in which the Commission recently approved a multiparty, nonunanimous settlement agreement, subject to conditions, "as a reasonable resolution of PacifiCorp's request for a general increase in electric rates." *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.* (*PacifiCorp*), Docket No. UE-032065, Order No. 6, at 1, (October 7, 2004), *aff'd, State Attorney General v. State Util. and Transp. Comm'n,* Thurston Cy. Sup. Ct. No. 04-2-02511-4 (October 27, 2005) (slip op.).

28 In the *PacifiCorp* case, as in this one, the proposed settlement was opposed by both Public Counsel and ICNU. Among other contentions, those parties argued that the Commission was required to analyze and approve every individual adjustment that comprised the overall revenue requirement in the parties' settlement agreement, even though that agreement clearly was the product of negotiation and compromise. The Commission disagreed.

29 The Commission noted that the settlement agreement must be viewed as a whole, with a view to whether the "overall result in terms of revenue requirement is reasonable and well supported by the evidence." *PacifiCorp,* at 27, ¶ 62. The Commission noted that "[I]t is not theory but the impact of the rate order which counts," and that the "total effect" of the order, rather than the precise methods employed in arriving at the end result, is what must be examined. *Id.* at 24, ¶ 53 and fn. 43 (*citing US. West v. Utils. and Transp. Comm'n,* 134 Wn.2d 48, 70, 949 P.2d 1321 (1997), and *Federal Power Comm'n v. Hope Nat. Gas Co,* 320 U.S. 591 (1944)).

30 As in this case, the parties in *PacifiCorp* included several individual revenue requirement adjustments as a part of the negotiated settlement. Public Counsel and ICNU argued that because these were essentially "a means to an end,"-- items that were the product of compromise, and hence not necessarily derived by mathematical formulas -- that the settlement was somehow a "black box" that must be rejected. Again, the Commission disagreed: "This implied criticism ignores the fact that all settlements have a so-called black box quality to one degree or another—they are by nature compromises of more extreme positions that are supported by evidence and advocacy." *Id.* at 26-27, ¶ 61.[1] This is precisely what Staff witness Mr. Braden has pointed out in this case, both in his rebuttal testimony

[1] In a footnote, the Commission also noted that "Public Counsel and ICNU have been parties to many settlements presented to, and approved by, the Commission, including settlements that lack even the level of analytical detail present here." *Id.* at 27, fn. 52.

and at the hearing: namely, that the settlement is the product of compromise, and many elements are not based upon formulas agreed upon by all of the settling parties; and that this contrasts with the typically more "bookend"-like positions that parties advocate for in litigation. Ex. 4 at 2-3; Tr. at 273-74, 282-86.

31 The Commission did indicate that it would examine individual adjustments to determine if any of them were contrary to law or "offend[ed] public policy," and to determine if the evidence supports the proposed elements of the Settlement Agreement as a reasonable resolution of the issues at hand. Otherwise, "except to the extent they help us understand the compromise nature of the parties' agreement to an overall revenue requirement, and to give us insight into things the settling parties considered in arriving at their compromise, close individual scrutiny of the individual adjustments is not required." *PacifiCorp,* at 26-27, ¶¶ 59, 62.

32 The Settlement Agreement is supported by substantial evidence in the record, and falls well within the range of reasonable outcomes as a "reasonable resolution of the issues at hand." *Id.* at 26, ¶ 59; Ex. 4 at 4. As the Commission has noted, "Ratemaking is not an exact science;" furthermore, the economic judgments required in rate proceedings often do not admit of a single correct result. *PacifiCorp,* at 27, ¶ 62, *citing US West,* 134 Wn.2d at 70 and fn. 43.

33 For the reasons set forth in greater detail below, Staff believes that the Settlement results in an overall revenue requirement and rates that are fair, just, reasonable, and sufficient, and is clearly in the public interest.

1. The return on equity of 10.4% in the Settlement Agreement is clearly a reasonable resolution of this issue.

34 The Settlement Agreement provides for a return on equity of 10.4%. Avista's original filed rate case asked for an equity return of 11.5%, while Public Counsel has asked for an equity return of 9.25%, and ICNU has asked for an equity return of 9.8%. Ex. 50 at 5; Ex. 261 at 5; Ex. 331 at 2. Avista, Public Counsel, and ICNU have filed extensive testimony and exhibits in support of their preferred litigation result. As is readily evident, the resolution of this issue in the Settlement Agreement is almost exactly halfway between the Avista and Public Counsel positions.

35 The 10.4% return on equity is also clearly within the range of reasonable returns, based on both this Commission's recent precedent and that of state public utility commissions throughout the country. In the most recent Puget Sound Energy rate case, a fully litigated case decided in February 2005, the Commission granted PSE a 10.3% return on equity. *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640 and UE-040641, Order No. 06, at 32, ¶ 80 (February 18, 2005). In contrast to PSE, Avista has credit ratings that are below investment grade, and they are anticipated to remain there until at least 2006. Ex. 1 at 9. This additional risk for investors certainly justifies an additional 0.1% in the return on equity.

36 Moreover, Regulatory Research Associates' July 6, 2005, publication (Regulatory Focus) reports that the average equity return authorization by state commissions nationwide for the first six months of 2005 was 10.36% for electric utilities (based on 16 rate cases), and 10.56% for natural gas utilities (based on eight rate cases). Ex. 1 at 14. The 10.4% return on equity in the Settlement Agreement falls well within the reported average ranges, and is clearly reasonable as a negotiated solution to this issue.

37 When one considers the weighted cost of capital (return on equity multiplied by the common equity ratio) that state commissions have authorized in other recent cases, the comparison also confirms the Settlement Agreement to be reasonable. The weighted cost of capital in the Settlement Agreement is 4.16% (10.4% times the agreed-to common equity ratio of 40%). This is less than: PSE's most recent authorized cost of 4.43% in Washington; Avista's authorized cost of 4.43% in Idaho (following a fully litigated electric and natural gas case); Avista's authorized cost of 4.95% in Oregon; and PacifiCorp's pending settlement of 4.75% in Oregon. *Id.*

2. The equity ratio of 40% in the Settlement Agreement is identical to Public Counsel's preferred outcome, and clearly is a reasonable resolution of this issue. In addition, the Settlement Agreement imposes automatic rate reductions if Avista does not increase its actual utility equity ratio in 2007 and 2008.

38 The Settlement Agreement provides for an authorized equity ratio of 40% for ratemaking purposes. This is less than Avista's request in its original filed case for

a 44% equity ratio (Ex. 32 at 2), and is identical to Public Counsel's recommendation on this item (Ex. 261, at 47). It is clearly a reasonable resolution of this issue.

39 Staff shares the concerns of Public Counsel that Avista's actual utility-only equity ratio is currently less than 40%. Public Counsel witness Mr. Hill recommends that the Commission provide incentive for the Company to improve the equity ratio of it utility-only capital structure. Ex. 261, at 48. The Settlement Agreement addresses this concern by including an equity-building mechanism, under which Avista is required to increase its actual utility equity component to 35% by December 31, 2007, and to 38% by December 31, 2008. If it does not meet these targets, there will be an automatic 1% reduction in base utility rates, spread uniformly across all classes (2% if neither target is met). These provisions afford actual and substantial benefits to the ratepayers. The equity ratio provisions of the Settlement Agreement are clearly reasonable.

3. Public Counsel's Production Property Adjustment should not be adopted by the Commission, because this issue is addressed by the Retail Revenue Credit in the Energy Recovery Mechanism (ERM), and adopting the proposed adjustment would improperly double-count for the same item.

40 As noted above, the Commission need not rule upon every individual adjustment comprising the negotiated Settlement Agreement to determine that the overall agreement is just, fair, reasonable, and sufficient. However, Staff believes

that certain of the adjustments proposed by Public Counsel or ICNU in this case are not proper and should not be adopted.

41 One such adjustment is Public Counsel's proposed production property adjustment. This is an adjustment that has been used in Puget Sound Energy rate cases. As Staff witness Mr. Parvinen explained at the hearing, however, Avista's Energy Recovery Mechanism (ERM) has a retail revenue credit component that addresses the same issue that the production property adjustment is meant to address. Tr. 197-199. As Mr. Parvinen said in a response to a question from Chairman Sidran:

> Q: . . . Do you agree or disagree with Mr. Norwood's testimony, which is I take it to the effect that the production credit is already factored into the ERM and that it would be in effect double counting if you were to follow the suggestion raised by Public Counsel that it be done in the rate base?
>
> A: Yes, yes, I would agree with that.

Tr. 199-200. Mr. Norwood's rebuttal testimony explains in detail why and how this double-counting occurs. Ex. 11, at 7-11. The Commission should not adopt this proposed adjustment, which would reduce the revenue requirement in the Settlement Agreement by $2.4 million. *See* Ex. 11, at 3.

4. The Commission should not adopt Public Counsel's proposed Boulder Park project adjustment, which would reduce rate base by $4.4 million. The Commission expressly found Avista's investment in the Boulder Park project to be prudent in a prior proceeding, based on Staff's analysis of this issue.

42 Public Counsel proposes that Avista's rate base be reduced by $4.4 million, reflecting a disallowance of the Company's acquisition of the Boulder Park project. Ex. 281, at 26-28. This adjustment should be rejected. Public Counsel relies solely on an Idaho order addressing this issue. That order, however, is not binding here. Boulder Park is a power supply project initiated by Avista in 2001, and placed into service in 2002, to install additional power capacity. This Commission expressly addressed the prudency of this project in June 2002, in an order approving a settlement agreement in Avista's general case to which Public Counsel was a party. The Commission expressly noted that Staff had examined the costs involved with new power supply projects, including Boulder Park, and found that these projects were prudently acquired. The Commission found:

> Staff also addresses new power supply costs, the prudence of which was reserved as an issue for the general rate proceeding. *Exhibit No. 14 (Staff Memorandum) at 15-20.* These costs include those associated with the Company's fifty-percent ownership in the Coyote Springs II generation project, its Boulder Park project, and the Kettle Falls CT generation project. "Staff believes [these projects] will provide benefits in the form of firm energy supply and a reduction in exposure to the more volatile wholesale markets." *Exhibit No. 14 (Staff Memorandum) at 15.* Staff states that based on its analysis, "these projects were prudently acquired and that the Company should be allowed to recover associated costs, including capital costs, interest, depreciation, and non-fuel O&M costs on a prospective basis. *Id. at 15-16.*

WUTC v. Avista Corporation, Docket No. UE-011595, Fifth Supplemental Order at 11-12, ¶ 24 (June 18, 2002). The Commission's decision on these issues was consistent

with these findings. *Id.* at 12, ¶ 27. No evidentiary record exists in the present case to overturn the Commission's prior order concerning Boulder Park, or to adopt the proposed Public Counsel adjustment.

5. The Settlement Agreement's use of a 50-year hydro normalization is the same methodology that Staff advocated and the Commission adopted in the most recent Puget Sound Energy rate case, and is clearly reasonable.

43 The Settlement Agreement uses a hydro normalization methodology based on the average of 50 separate simulations run through the AURORA model to determine normalized hydropower production estimates for the rate year. The hydrological data used is that from 1928-1979. Ex. 1 at 19. ICNU suggests that this method is unreasonable, and that a 40-year rolling average must be used instead. Ex. 301 at 22. ICNU's challenge to the 50-year methodology is clearly without merit.

44 The 50-year methodology used in the Settlement Agreement is the same as that for which Staff advocated, and the Commission adopted, in the recent PSE general rate case. *WUTC v. Puget Sound Energy Inc.*, Docket Nos. UG-040640 and UE-040641, Order No. 6, at 49-51, ¶¶ 124-130 (February 18, 2005). The Commission specifically relied upon Staff witness Dr. Miriam's analyses that demonstrated "not only that the 50-year stream-flow data is trendless and normally distributed but also that there is a high degree of correlation between streamflow and hydro generation." *Id.* at 50, ¶ 128. The Commission concluded:

> We find on the basis of the current record and the clear and convincing argument by Staff and PSE that the method presented by Dr. Mariam, based on 50 years of data, is a superior alternative to the 40 year rolling average.

Id. at 51, ¶ 130.

45 Furthermore, on cross-examination it became clear that the 40-year rolling average advocated by ICNU witness Mr. Falkenburg actually produced skewed and anomalous results, which was confirmed by his own exhibits. Tr. 666-671; Ex. 304 at 2, 23. His methodology chooses years that were above-average rainfall years, and notably excludes several below-average and drought years, even though the evidence indicates that droughts (such as that of the 1930's) are "likely a typical fluctuation in the Columbia River system." *Id.* at 23. Avista witness Mr. Kalich's rebuttal testimony exhibits clearly illustrate that the rainfall years selected by Mr. Falkenburg are not representative. Ex. 174 at 5-8 and Illustrations 2-3.

46 In conclusion, the Commission has just recently confirmed that the 50-year hydro methodology is the preferable method by "clear and convincing" evidence, and the use of that method in the Settlement Agreement to determine normalized hydropower production estimates for the rate year is clearly reasonable.

6. ICNU's proposed hydro-shaping adjustment should be rejected because it does not accurately portray how Avista's hydro system operates.

47 ICNU proposes a "hydro-shaping" adjustment that would reduce Avista's revenue requirement in the Settlement Agreement by approximately $2.8 million.

See Ex. 301 at 4. However, as both witnesses for the Company and Staff has noted, this adjustment is based on flawed premises and is not justified. Mr. Kalich points out that ICNU's hydro modeling allows for only two levels of generation across an entire month—minimum and maximum. "This assumption is not only simplistic, it has no basis in how our Company can run it system." Ex. 174 at 18. Mr. Norwood further explained the erroneous nature of ICNU's proposed adjustment at the hearing, noting that hydro resources cannot be modeled in the same way as thermal resources. Tr. at 765-769; Ex. 323 and 324. Staff witness Mr. McIntosh also explained why the ICNU hydro shaping model is incorrect:

> Because I think that hydro is typically used in Avista's system to clip loads, not extract economic rents. However, what that means is it's not a profit taking operation. It sometimes is the case that their load hours and high price hours are determinate, but the operation is– low load hours are--the dispatch of hydro, which is primarily run of the river, to clip peaks.

Tr. at 218-219. The ICNU proposed hydro shaping adjustment is not an accurate adjustment and should not be accepted by the Commission.

7. The revenue requirement in the Settlement Agreement of $22.1 million for electric and $968,000 for natural gas is clearly reasonable as a negotiated compromise of the issues in this case.

48 The revenue requirement in the Settlement Agreement is $22.1 million for electric and $968,000 for natural gas. Avista's revised revenue requirement proposal (for litigation purposes) is $33.4 million for electric and $2.6 million for

natural gas. Ex. 11 at 5. Public Counsel's revised proposed revenue requirement is $6.4 million for electric and -$114,000 for natural gas. Ex. 236 at 1; Ex. 237 at 1.

49 However, as set forth above, several adjustments can clearly be made to the Public Counsel and Avista proposed amounts to demonstrate the reasonableness of the Settlement Agreement. Examining first the electric side, if one adjusts Public Counsel's $6.4 million figure by using a 10.4% return on equity instead of 9.25%, this adds $5.9 million. Ex. 11 at 3. If one does not adjust for Public Counsel's production property adjustment, which is already accounted for by the retail revenue credit in the ERM, this adds another $2.4 million. *Id.* If one does not adopt the ICNU hydro shaping adjustment which Public Counsel has incorporated, this adds another $2.8 million. And if one does not adopt the proposed Boulder Park adjustment (which clearly is not justified given the Commission's prior order governing this matter), this adds approximately another $0.6 million to the revenue requirement. ($4.4 million to rate base). These four changes *alone* would bring Public Counsel's $6.4 million figure to approximately $18.1 million.[2] Likewise, if Avista's $33.4 million litigation figure is adjusted for the use of a 10.4% return on equity instead of 11.5%, this change *alone* reduces Avista's litigation figure by $6.1 million, to approximately $27.3 million.

[2] Public Counsel did not incorporate ICNU's proposed 40-year rolling average for hydro into its calculations, Ex. 287 at 15, and such an adjustment, as set forth above, is clearly not justified.

50 The Settlement Agreement amount of $22.1 million is well within the $18.1 million to $27.3 million range—indeed, it is closer to $18.1 million. Furthermore, this does not include possible further adjustments that the Commission might make regarding *any* of the multitude of unresolved revenue requirement issues. Both Avista and Public Counsel/ICNU have submitted substantial testimony and exhibits on these unresolved issues. Staff believes that when the Settlement Agreement is regarded in this light, it is clearly a reasonable resolution.

51 On the natural gas side, the Settlement Agreement's use of a 10.4% return on equity, rather than 9.25 % or 11.5%, accounts for nearly all of the difference in the differing revenue requirement amounts. Again, this is clearly a reasonable return on equity for settlement purposes, and the resulting amount of $968,000 for natural gas is likewise reasonable.

8. The Settlement Agreement's resolution of ERM issues is reasonable and beneficial to all parties.

52 The Settlement Agreement, as noted above, provides for a reduction of the so-called "deadband" amount in the ERM—that is, the amount for which the Company absorbs all impacts, both positive and negative. Currently, this amount is $9 million. Avista had requested that the deadband be completely eliminated. The Settlement Agreement arrives at a compromise reduction of the deadband to $3 million. Ex. 1 at 27-28.

53 The Settlement Agreement also increases the surcharge for the ERM by 10% over current levels (approximately $2.7 million). This will allow the deferral balance of about $100 million to be paid down more rapidly, which will in turn allow the Company to buy back more debt, build the equity component, and improve its financial health more quickly. *Id.* at 28.

54 In addition, the Settlement Agreement provides that prior to December 31, 2005, the Company will initiate discussions among all interested stakeholders concerning any other possible changes to the ERM. Ex. 2 at 5, section 13(C). The Settlement Stipulation in Docket No. UE-011595 had previously set this review date at "on or before December 31, 2006." This one-year advancing of the review date represents a significant benefit to all parties.

9. The Settlement Agreement provides for a reasonable compromise on rate spread and rate design.

55 Finally, the Settlement Agreement contains some relatively minor shifts from Avista's initial proposal with regard to rate spread, generally moving toward parity; that is, the concept that customers essentially pay an amount equivalent to the cost a providing them service among the various classes. Tr. at 155; Ex. 2 at 5-6, Section 14. The resulting rate spread and rate design, which is fully explained and set forth in the parties' Joint Testimony, results in rates that are fair, just, reasonable, and sufficient. *See* Ex. 1 at 29-39.

IV. CONCLUSION

56 The Settlement Agreement that was negotiated among four of the six parties to this case—Avista, Staff, the Energy Project, and ICNU—represents a compromise among many differing points of view to resolve the Company's pending rate case. All of the signing parties made concessions to reach a reasonable balancing of interests. The end product results in significantly lower increases to Avista's electric and gas rates than was requested in either the Company's original or revised filing.

57 The Settlement Agreement also includes an equity-building mechanism that will require Avista to increase its utility equity component over the next three years or be subject to automatic reductions in base utility rates; modifications to the Company's Energy Recovery Mechanism (ERM); and commitments by Avista to increase funding levels for two existing programs whose purpose is to assist limited-income customers. Because the Settlement Agreement results in rates that

are fair, just, reasonable, and sufficient, Staff recommends that it be approved by the Commission.

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Respectfully submitted,

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