BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	DOCKET NO. UE-050482 DOCKET NO. UG-050483

BRIEF OF PUBLIC COUNSEL

November 14, 2005

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I. INTRODUCTION

1. Public Counsel urges the Commission to reject the agreement between Avista and Commission Staff to increase electric rates by a total of approximately $25 million for customers in Spokane and the Eastern Washington service territory. Public Counsel also opposes the gas portion of the settlement. The proposed rates are not just and reasonable and the settlement is not in the public interest. The settlement contains a number of serious weaknesses. A number of important issues that should be brought to the Commission for resolution have instead been compromised, many in a "black box" fashion, to the detriment of Avista's residential and business customers. This is not a time when rate increases should be imposed on the basis of accommodations or "splitting the baby." Avista customers deserve and expect that in an era of dramatic energy cost increases, their rates will only be increased after a thorough review to ensure that no excessive or unneeded revenue is collected from customers. Public Counsel does not recommend approval of the settlement with conditions unless the modifications address the major areas of concern discussed in this brief.

II. SUMMARY: THE PROPOSED SETTLEMENT BETWEEN AVISTA AND THE COMMISSION STAFF IS NOT IN THE PUBLIC INTEREST

A. The Settlement Is Not Fair to Avista's Customers and Is Not Justified By the Record.

2. The settlement should not be approved for the following reasons.

3. Cost of Capital. The return on equity (ROE) of 10.4 % is not supported by any direct evidence and is excessive, as shown by the careful analysis of Public Counsel and ICNU cost of capital experts, and Dr. Avera's own Discounted Cash Flow (DCF) analysis. In addition, Avista Utilities is asking its rate payers to provide it a subsidy by paying equity returns on overall corporate equity that does not exist in the regulated utility. Public Counsel supports a hypothetical capital structure in this case only in the interests of financial soundness for the

Company, and only if coupled with a strong equity building mechanism equivalent to that used for Puget Sound Energy (PSE). The settlement mechanism is a weak substitute.

4. Revenue Requirement. The proposed settlement electric revenue increase of $22.1 million (not including surcharge) is not supported by the record. Public Counsel recommends that Avista receive no more than a $6.4 million revenue increase for electric revenues. On a range of issues, including Production Property, Coyote Springs, and the Rathdrum Lease, Avista and Staff have provided little support, or offer inconsistent and outcome-oriented methodologies and calculations that serve only to increase revenue requirement. In addition, a number of the proposed adjustments in the settlement violate Commission precedent.

5. Energy Recovery Mechanism (ERM). Avista's current ERM was not designed to be a long-term power cost adjustment (PCA) consistent with this Commission's well-established criteria. Rather than addressing these structural problems, the settlement accommodates Avista's one-sided shift of risk from shareholders to ratepayers by significantly reducing the deadband without any compensating benefits. The settlement also does not address Avista's "hidden" change to the ERM retail revenue credit factor. Public Counsel witness Merton Lott presents a comprehensive alternative proposal to improve the ERM.

6. Rate Spread. The rate spread decision in this case will determine which customer classes will pay what share of any increase ordered. Avista's proposal, essentially adopted by the settlement, relies on an electric cost of service study and methodology that the Commission has never accepted. As a result, the settlement rate spread places a disproportionate share of the rate increases on residential and small commercial customers, despite the undisputed facts in the record showing that those classes are not responsible for the growth in Avista's load. Public Counsel witness Mr. Lazar presents a superior alternative rate spread.

7. Rate Design. The settlement puts the majority of the residential electric increase on the first rate block (first 600 kWh) of usage. This does not accurately reflect the cost of resources,

and puts an additional burden on gas heat customers who will also be experiencing other severe price increases.

8. Low Income. Contrary to assertions by proponents, the low-income settlement does not provide any new funds overall for rate assistance and DSM over and above Avista's existing funding levels. The increase comes from restoration of funding levels that would likely have occurred in any event. The programs involved serve only a minority of those eligible, providing no benefit to others vulnerable to the general increases imposed by the settlement The settlement also contains a troubling element--a two year cap on the natural gas tariff rider-- which will limit the program's flexibility to react to future energy price increases until 2008. Public Counsel opposes this element of the low-income settlement.

9. Public Comment. Testimony at the hearing in Spokane, as well as written comments received via e-mail and letter reflect significant concern with and opposition to the proposed settlement rate increase from a broad range of consumers, including seniors, elected officials, small and large businesses. These statements about the real-world impact of increases in the Spokane region underline the need to ensure that any revenue increase occur only after a careful review and that it be no larger than absolutely necessary.

B. Public Counsel Revenue Requirement Recommendation.

10. Public Counsel's revenue requirement recommendation for Avista's retail customers in Washington is as follows:

Electric rate increase: $6,404,0000

Gas rate decrease: $114,000

These figures incorporate adjustments incorporated within the settlement and ICNU adjustments adopted by Public Counsel. The recommendations are set forth in Mr. Dittmer's Rebuttal testimony, Exhibit 235, pp. 1-3, his Revenue Requirement Summary (Electric), Exhibit 236, and Revenue Requirement Summary (Gas), Exhibit 237. These figures represent a maximum

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recommendation. Any additional ICNU adjustments adopted would be incremental to the Public Counsel figures.

Comparisons between Public Counsel recommendations and those in the settlement are contained in Exhibit 289 (Lott) and Exhibit 376 (Public Counsel's Response to Bench Request No. 4).

C. The Standard of Review.

1. The Commission has set a clear framework for setting rates that is applicable in this case.

11. As the Commission stated in Avista's last fully contested gas and electric rate case, the "ultimate determination" which must be made by the Commission in a rate proceeding is "whether the rates and charges proposed in the revised tariffs are fair, just, reasonable and sufficient, pursuant to RCW 80.28.020." *WUTC v. Avista* Corporation, Docket Nos. UE-991606, UG-991607, Third Supplemental Order (September 2000)("1999 rate case"), ¶ 14. The Commission elaborated:

> These questions are resolved by determining the Washington intrastate adjusted results of operations during the test year, establishing the fair value of the Company's property-in-service for intrastate service in the state of Washington (rate base), determining the proper rate of return permitted the Company on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return.

Id., ¶ 14.

The Commission went on to explain in more detail the analysis required in the setting of fair rates:

> In order to accomplish these tasks, the *parties in a rate proceeding develop evidence* from which the Commission may determine the following:
>
> 1) The appropriate *test period* ....The test period is used for investigation of the Company's operations for purposes of the proceeding;
>
> 2) The Company's *results of operations* for the appropriate period, adjusting for unusual events during the test period, and for known and measurable events;

3) The appropriate *rate base*, which is derived from the balance sheets of the test period. The rate base represents the net book value of assets provided by investor's funds which are used and useful in providing utility service to the public;

4) The appropriate *rate of return* the Company is authorized to earn on the rate base established by the Commission;

5) Any existing *revenue excess or deficiency*; and

6) The *allocation* of the rate increase or decrease, if any, fairly and equitably among the Company's rate payers.

Id., ¶¶ 15-21. (emphasis added).

Any rates approved in this case, whether as a result of the multiparty settlement, or based on other recommendations, must meet this standard. As argued in detail in this brief, Avista and Staff have failed to provide the evidence necessary to support their settlement under these parameters.

12. In addition, the Commission must regulate in the public interest. RCW 80.01.040(3). Both contested rate determinations, and settlement approvals are based upon a determination that the result is in the public interest. *Id.*, ¶ 449 (contested rates); *WUTC v. Avista Corporation,* Docket No. UE-011595, Fifth Supplemental Order (June 18, 2002)(2001 electric rate case all-party settlement approval).

2. These ratemaking rules are applicable in the special procedural posture of this case.

13. The Commission has determined that, due to the presentation of a multiparty settlement, the case at this juncture will focus on the propriety of the settlement. At the outset of the hearing, Administrative Law Judge Caille stated:

> The purpose of the hearing is to determine whether the Commission should accept the settlement agreement, accept the settlement agreement with conditions, or reject the settlement agreement. If the Commission rejects the settlement agreement or accepts the settlement agreement with conditions that are unacceptable to the settling parties, then there will necessarily be further process,

and generally this means that the litigation returns to the status at the time the settlement was offered. Tr. 129: 4-14. *See also,* Order No. 04, ¶13.[1]

14. The stated scope of the hearing, however, does not change the fact that in order to set rates, either by approving the settlement, or approving it with conditions, the Commission must make the findings described in the previous section, on the basis of a preponderance of credible evidence in the record. Public Counsel has presented evidence on all the issues in the ratemaking framework described.

3. The burden of proof in this case lies with Avista and the settling parties.

15. The burden of proof is on Avista to establish that the proposed rates which would result from the settlement are fair, just, reasonable, and sufficient. RCW 80.04.230(2). By virtue of the settlement, that burden also falls upon the joint settling parties who "must present sufficient evidence to support its adoption under the standards that apply to its acceptance." WAC 480-07-740(2)(b).

16. In this case, however, the main settling parties have not provided sufficient support for the settlement. Two primary types of support are offered. Avista relies chiefly on its initial filing, supplemented by rebuttal testimony, and upon the Joint Direct testimony in support of the settlement. Exhibit 1. Staff has no technical testimony at all, other than the Joint Direct. The Joint Direct testimony is a cursory and largely descriptive document that presents little if any factual or analytical support on any issue. On close review, therefore, the evidence presented by Avista and Staff does not provide a record for approval of the settlement. It is does little more state (a) Avista's initial position as an outer parameter to justify the settlement, and (b) a recapitulation and brief explanation of the settlement terms.

17. In applying the burden of proof, it is important to recognize that every issue is contested. Public Counsel and ICNU have presented extensive countervailing testimony on every major component of both the initial rate filing and the settlement. Public Counsel's evidence is more

[1] Public Counsel objected to this limitation on the scope of the hearing. *Public Counsel Answer to Joint Motion for Procedural Schedule*, August 17, 2005.

than sufficient to allow the Commission to approve a different revenue requirement, rate of return, and rate design. Given the stated narrower scope of the issues at this stage, however, Public Counsel's evidence is also more than adequate to (a) provide a basis for adopting additional conditions to the settlement; or (b) alternatively, establish a prima facie case that the settlement should be rejected and that the case should be set for further proceedings.

18. Avista, Staff, and the other settling parties cannot carry the burden of proof by simply pointing out that the settlement revenue level is lower than the initial request, and by relying on the cursory overview in the Joint Direct. Exhibit 1. Because all the basic issues in the case are contested, they must show, in light of the entire record, including the opposing evidence, that their specific settlement rate proposals are supported by the preponderance of credible evidence on every point.

19. A settlement does not effect any delegation of the Commission's authority to other parties. The Commission must still, as noted above, make an independent determination on the record that the statutory requirements are met. It is up to the Commission, not the Company, Staff, or another party to make this decision, and to perform the necessary balancing of all interests. The Commission's rules recognize this by requiring settling parties to file supporting testimony and to present it at a hearing. *See generally,* WAC 480-07-740. As a practical matter, in the case of an all-party settlement (a "full settlement"), the absence of disputed issues of fact makes the Commission's task of evidentiary review more manageable, and the agreement of all affected parties can provide the Commission confidence in the balance and fairness of the settlement.

20. The Commission faces a special challenge when reviewing a multiparty settlement. As the Commission's rules recognize, a multiparty settlement is different in kind from a full settlement. A "full settlement" is "[a]n agreement of all parties that would resolve all issues in a proceeding." WAC 480-07-730(1). A "multiparty settlement," by contrast, is "[a]n agreement of some, but not all, parties on one or more issues [and] *may be offered as their position in the*

proceeding along with the evidence that they believe, supports it." WAC 480-07-730(3)(emphasis added). The rules recognize, therefore, that a multiparty settlement does not present full resolution of all issues, but merely a joint position that can be presented in the course of the proceeding, and must be measured against contrary evidence.

21. In reviewing the joint position presented here, the Commission should not give undue weight to this partial agreement, or elevate it to the level of a "full settlement." The Commission should also guard against efforts by the settling parties to create a sense of urgency or inevitability for the settlement. The settling parties recommended that the hearing be limited to review of the settlement, thus voluntarily accepting that further process could be necessary. There should be no implication that the settlement should be approved simply to avoid the burdens of that additional process.

22. Staff's role in the case is discussed further below. However, it is worth noting that Staff appears to a great extent have deferred to Avista to carry the burden of proof on the settlement. Tr. 271:19-21 (Braden). Staff has not filed testimony, other than joining in the Joint Direct. Exhibit 1. Its only response to the issues raised by four Public Counsel and three ICNU witnesses in several hundred pages of testimony and exhibits was the five page rebuttal of Roger Braden, a policy witness, which did not address any of the specific issues raised by Public Counsel. Exhibit 4. Tr. 270:23-270:4 (Braden); Tr. 270:19-22. Staff chose not to present any accounting, economic or financial testimony by any of the qualified personnel who participated in the case to rebut Public Counsel on any issue. Neither did Staff present any cross-examination exhibits or conduct any cross-examination of Public Counsel witnesses to challenge their evidence.

4. This settlement should not be approved on the basis of game theory.

23. Staff witness Roger Braden's written testimony and responses to cross-examination find significant support for the settlement in two areas: (1) the suggestion that Public Counsel (and ICNU) positions are by definition suspect because they are so-called litigation positions; and (2)

the related point that the settlement is fair because it is a mid-point. Neither argument withstands scrutiny. However inadvertently, these arguments seem to reflect a rather jaundiced view of stakeholder participation and an unduly cavalier approach the complex factual determinations involved in Commission ratemaking.

a. Civil litigation analogies do not accurately describe WUTC practice.

24. Drawing on his experience as a trial attorney, Staff witness Roger Braden dismisses the evidence of Public Counsel as merely a "litigation position" of a "bookend character" at "one end of the spectrum." Tr. 273:12-13. Exhibit 4, p. 2, ll. 20-23. He characterizes Public Counsel's positions in the case as relatively "extreme." Tr. 273:22-24. Since Mr. Braden has made these assertions it is necessary to address them here, particularly because they form much of the basis of his argument in favor of the settlement.

25. These opinions are unfounded and betray a misunderstanding of the nature of regulatory proceedings. In civil litigation, a party's initial positions are stated in pleadings drafted by counsel and generally filed prior to significant discovery. Testimony and evidence in support of the pleading allegations is not presented and tested until the time of trial, or perhaps summary judgment. Parties may take "litigation positions" to preserve their strongest case until they are able to do discovery and marshal evidence, and may amend pleadings as the evidence develops. Amounts of damages sought may be alleged with an eye to the position in settlement negotiations.

26. Positions of parties, including Public Counsel, in WUTC rate proceedings are developed in a far different fashion. The Company, as Avista did here, initiates the case with extensive factual testimony and exhibits. Public Counsel's position in the case is not presented until it has conducted extensive analysis and discovery with the assistance of subject matter experts retained for the purpose. Public Counsel does not file a pleading with a litigation position stated in allegation form by counsel. Instead, it presents factual statements and recommendations in detailed written expert testimony, supported by exhibits, which we know will be subject to

detailed discovery, written rebuttal, and ultimately presented under oath for cross-examination before the Commission. This requires a substantial investment of resources. Reasonableness, credibility and defensibility of the evidence is critical. Extreme and baseless assertions would waste limited resources and could cause long-term harm to Public Counsel's ability to effectively and credibly represent consumers before the Commission.

27. For these reasons, neither Public Counsel, nor we suspect other parties before the WUTC, can afford the type of unsupported posturing that Mr. Braden suggests. On cross-examination, Mr. Braden seemed to retreat from these arguments somewhat. He acknowledged that the Commission has been known to adopt litigation positions, Tr. 274:17-18, and that a litigation position could, in fact, be "the right answer." Tr. 286:8-24. He also conceded that Staff itself would not want its litigation position in this case discounted as mere uncompromised litigation advocacy. Tr. 275:11-16.

b. Ratemaking is not merely picking a number between bookends.

28. As noted above in the discussion of standards of review, the Commission's task in a rate case is to set rates at the proper level based on a detailed set of findings regarding the Company's actual financial position. While Mr. Braden acknowledges these parameters, though hesitantly, on cross-examination, Tr. 285:19-286:7, he seeks to "emphasize the nature of the process as being more beyond a certain point a matter of judgment and compromise as opposed to formulas and numbers…[G]etting into the weeds on specific adjustments at this stage was going to be counterproductive in light of the nature of the settlement and how it was achieved." Tr. 282:19-25. In the end, Staff seems to be arguing that the settlement is reasonable, in large measure, simply because it represents a mid-point or compromise between the parties' positions. It is a judgment call, not a mathematical analysis, made by Staff, that the settlement fairly balances the parties' positions. Tr. 285:1-19. If that argument is accepted, it is possible to defend the selection of any number between Avista's and Public Counsel's recommendation, whether or not supported by the record. Hearings could be dispensed with. Public Counsel does not believe

that this case is properly resolved by simply picking a number somewhere in the middle, either as a matter of law, or as a matter of technical ratemaking analysis. Avista's customers are entitled to more care than this before they are asked to higher rates.

5. Staff's role in the case does not provide support for the settlement.

29. Historically, Staff has played a salutary role as a party before the Commission. It has used its resources and expertise to present to the Commission thorough technical and policy analysis of the issues before it, in order to assist the Commission in making an informed decision on a complete record. This is a particularly important role where, as here, the Commission has not had the opportunity for several years to review Avista's electric rates in a fully contested proceeding.

30. On cross-examination, Mr. Braden was asked to describe Staff's role in the case. He stated that:

> [O]ur role is to scrutinize the filing for accuracy, for compliance with the 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. Tr. 279:18-25.

Earlier, he stated his "personal belief that Staff's position is the only one in the current proceedings that represents everyone's interests." Tr. 275:20-22.

31. Public Counsel has some concerns with Staff's role in this particular case. First, while Staff argues that it has taken all interests and issues into account in reaching a settlement, and asks the Commission to accept that as a basis for approval, other than Exhibit 1 and 4, Staff has not shared its assessment of the merits of any specific issue with the Commission on the record of this case. Tr. 271:10-18; Tr. 283:6-8. This is does not help in providing the best record for decision or in allowing other parties to address Staff's conclusions. In addition, as discussed in the appropriate sections below, Staff appears to have agreed to a number of Avista positions on revenue requirement issues and the ERM that are not consistent with Commission orders, or with Staff's own prior advocacy.

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32. Public Counsel's second concern with this view is that it suggests that even though consumer interests are represented in the case by counsel, witnesses, and evidence, Staff can compromise those positions because it knows how to best address these interests and balance them against others. This is especially troubling in this case because Staff concedes on cross-examination that positions of Public Counsel (and ICNU) "have some validity to them." Tr. 281:21. Some of these points were included in the settlement, but others were not. *Id.* For those excluded from the settlement, Staff "made the judgment, as you do in settlements, that some things stay and some things go in the effort to seek what we feel is a fair balance." Tr. 282:7-12. In other words, issues raised by Public Counsel (and ICNU) that have some validity, were compromised by Staff in order to achieve settlement.

III. COST OF CAPITAL

A. Return on Equity (ROE).

1. Public Counsel's recommended 9.25% ROE meets all regulatory tests of a fair return.

33. A public utility with facilities and assets used and useful in public service is entitled to no more than a reasonable opportunity to earn a fair rate of return on its investment. The United States Supreme Court established the standard with which to evaluate whether a rate of return is fair in *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) (*Bluefield*), stating: "The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management. . .to raise the money necessary for the proper discharge of public duties." *Bluefield*, 262 U.S. at 693.

34. The Court also said that allowed rates of return should reflect the following:

> [A] return on the value of the [utility's] property which it employs for the convenience of the public equal to that. . .being made at the same time... on investments in other business undertakings which are attended by corresponding risks and uncertainties.

Bluefield, 262 U.S. at 692.

Twenty-one years later, the Court reviewed the issue of fair rate of return in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*). In *Hope*, the Court held that a fair rate of return "should be commensurate with returns on investments in other enterprises having corresponding risks" while being sufficient "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Hope*, 320 U.S. at 603. The Court noted that "[t]he rate-making process under the Act, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and consumer interests . . . and does not insure that the business shall produce revenues." *Id.* More recently, the Court stated that consumers are obliged to rely upon regulatory commissions to protect them from excessive rates and charges. *See Permian Basin Area Rate Cases*, 390 U.S. 747, 794-95 (1968) (*citing Atlantic Refining Co. v. Public Service Comm'n*, 360 U.S. 378, 388 (1959).

35. Public Counsel's recommended return on common equity capital of 9.25% fulfills all of these legal requirements. The 9.25% return on equity works to assure the financial soundness of Avista Utilities and provides a return commensurate with returns of similar-risk firms, which will allow the Company to continue to be able to attract the capital necessary to fulfill its customer service obligations.

36. 1) Assure financial soundness: As noted in Exhibit 261, p. 5, a 9.25% equity return, operating through a supportive hypothetical capital structure provides the Company an opportunity to achieve a pre-tax interest coverage of 2.27 times. That interest coverage level is greater than the interest coverage actually earned (1.50 times) by Avista Utilities over the last three years. Also, Public Counsel's overall return recommendation is predicated on using a hypothetical capital structure, i.e. one that contains more common equity and less debt capital than that actually employed by the Company. This approach was selected specifically to support the Company's financial integrity. Exhibit 261, pp. 46, 47. This capital structure recommendation requires rate payers to provide a return on a portion of Avista's rate base that is actually financed with debt capital, and thus calls for a $5.3 Million annual capital cost subsidy

by Washington rate payers. Exhibit 278, p. 8. Accordingly, through both the improvement in the interest coverage ratios and the use of a hypothetical capital structure, Public Counsel's recommendation fulfills the Court's requirement of supporting the regulated entity's financial position.

37. 2) Attract Capital: A 9.25% return on common equity for Avista Utilities is similar to returns investors require from similar-risk firms and is supported by substantial evidence provided by all cost of capital witnesses in this case. Because the 9.25% return on equity is similar to the returns investors require for other similar-risk firms, it will ensure that the Company will continue to be able to attract capital, as required by the regulatory guidelines set out by the Court. The evidence supporting the efficacy of a 9.25% equity return in the record in this case is substantial:

- DCF Evidence – The Discounted Cash Flow (DCF) method is, by far, the most widely used econometric methodology used to estimate equity returns in regulated rate proceedings. Exhibit 50, p. 40 (Avera Direct); Exhibit 261, pp. 74. The DCF provides the most reliable estimate of the cost of equity capital and is the equity cost estimation method on which this Commission has long relied. Exhibit 261, p. 75 All of the witnesses in this proceeding—working independently—have presented DCF evidence that indicates the 9.25% equity return recommendation of the Public Counsel is reasonable, and the 10.4% return requested in the settlement is excessive.

DCF ESTIMATES BY EXPERTS IN THIS PROCEEDING			
Hill (Ex. 272)	Avera (Original) (Ex. 50, p. 40)	Avera (Updated) (Ex. 261, pp. 80- 82)	Gorman (Ex 331, p. 15)
9.01%	9.80%	9.30%	8.80%

- Corroborative Evidence of Other Econometric Models – Public Counsel witness Hill's corroborative models support his DCF estimate and indicate a reasonable range of equity

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capital costs for similar-risk companies ranging from 8.54% to 9.14%.[2] Exhibit 261, pp. 65-66. Mr. Gorman's risk premium, if properly based on current bond yields would be 9.3% (Exhibit 278, p. 5). Similarly, Dr. Avera's CAPM and Risk Premium model results, if based on current bond yields, are 9.2% and 9.45%. (Exhibit 261, p. 93, and p. 88, respectively). One of Mr. Hill's corroborative methods is the Market-to-Book ratio (MTB). During cross-examination Dr. Avera, referred to several concerns expressed by author Dr. Morin regarding the application of an MTB equity cost analysis. Tr. 394:7-396:6. Exhibits 74,75. Morin calls for the use of expected returns rather than currently allowed returns, indicates that the regulated Company should have an opportunity to earn the allowed return (a standard ratemaking assumption) and, if diversified, the Company should have a market-to-book ratio above 1.0. Mr. Hill's MTB analysis meets all those cautionary criteria.

- Investor Return Publications - Investor services are advising their subscribers to expect returns from similar-risk investments that average 8.4%—below the Public Counsel recommended equity return of 9.25%. Exhibit 261, pp. 19, 20.
- Observable Capital Costs are Historically Low – Equity capital costs are not directly observable and must be measured by econometric methods such as the DCF. Exhibit 261, p. 13. The capital cost rates associated with bonds (bond yields) are directly observable. Those data indicate that capital costs are currently at their lowest level in more that 40 years. Exhibit 266, p. 2. Also, even though short-term rates have increased over the past year due to monetary tightening at the Fed long-term interest rates have not increased and, in fact, have declined. Exhibit 261, p. 20.
- Lower Risk Premiums – New research in the field of financial economics indicates that the return premium required by equity investors over bond returns is substantially lower

[2] Mr. Hill's recommended range of equity capital costs of 8.75% to 9.50% is conservative (i.e., on the high side). His corroborative models are the Capital Asset Pricing Model (CAPM), the Modified Earnings Price Ratio (MEPR) analysis, and the Market-to-Book Ratio (MBR).

than previously thought, or than is indicated by historical averages. The most widely-used indication of equity returns over bond return is the historical data published by Ibbotson Associates. Those data indicate that over the past 70 years equity investors have earned a 6.5% return above long-term Treasury bonds. However, new research by prominent economists indicates the risk premium required by equity investors in the future is much lower—3% to 4.5%. With current T-bonds yielding approximately 5%, a risk premium of 3% to 4.5% implies investor required equity returns of 8% to 9.5%. An equity return for lower-risk utility assets of 9.25% is generous by that standard. Exhibit 261, pp. 90-91.

- Market to Book Ratio Evidence – The market price of utility stock is substantially above book value. Exhibit 261, p. 30. Also, allowed utility returns have averaged 10.5% recently Exhibit 261, p. 5. In fact, the settling parties trumpet recent allowed returns as a rationale for the 10.4% return included in the settlement. Exhibit 1, p. 14. However, instead of supporting the parties' ROE request, those data indicate that investors' required returns (the cost of equity capital) must be well below 10.5%. Exhibit 261, pp. 30-37 (see discussion in next section).
- Changes in Taxation of Dividends – Because dividends are now taxed in the same manner as capital gains (i.e., at a lower rate than they have been in the past) that income stream is more valuable to investors. Because relatively higher dividend yields are a reason that many investors buy utility stocks, the change in the tax law has caused investors to value those stocks higher and has also caused the cost of capital of utility companies (the investors' required return) to decline.

2. The support offered for the settlement ROE of 10.4% is not credible.

38. The Joint Direct in support of the cites Regulatory Research Associates (RRA) reported equity returns during the first half of 2005 as support for the reasonableness of a 10.4% ROE recommendation. Exhibit 1, p. 14. The Joint Direct does not refer to the current level of

directly observable capital costs (interest rates) or how that current interest rate level relates to capital costs generally in recent years. The Joint Direct does not discuss similar risk companies, market prices, dividend growth rates, bond yields or any factors that are probative of the return investors currently require in order to invest in combination gas and electric firms similar in risk to Avista Utilities. None of the witnesses listed in the Joint Direct are cost of capital witnesses.

39. In fact, the RRA "evidence" offered by the Joint Direct regarding the efficacy of the 10.4% equity return actually indicates that the cost of capital is well below that level. As shown in Exhibit 275, that level of return is similar to the *accounting* returns that electric utilities similar in risk to Avista are expected to earn over the next three to five years. Moreover, investors are providing a market price for those companies that substantially exceeds the book value on which the 10% to 10.5% returns will be earned. Therefore, the market-based return the investor expects—the cost of equity capital to the firm—must be well below that 10%to 10.5% level. An equity return of 10.4%, therefore, overstates utility investors' required returns.

40. As Mr. Hill discussed in his rebuttal testimony, use of recent allowed returns has a number of problems. Exhibit 278, pp. 10-11. There is an element of circularity if each Commission relies on another in turn to guide it in setting returns. In addition, this Commission has had no opportunity review the individual factors that led to setting those returns in other states. It must rely on the evidence in this case. Finally, it is akin to piecemeal ratemaking. We have no evidence here of other state commissions' policies regarding rate base, expenses, depreciation, or other factors. *See.,e.g., Centerpoint Energy Arkla.,* Arkansas Public Service Commission Docket No. 04-121-U, Order No. 16, September 19, 2005, pp. 45-46 (rejecting reliance on other states' allowed returns).

41. The parties to the proposed settlement did not list Dr. William Avera as witness for the Joint Direct in support of the 10.4% ROE. However, as noted, Dr. Avera's own DCF results indicate that the actual cost of capital for Avista is well below that level. Dr. Avera's DCF

analysis included in his Direct Testimony indicates the cost of equity for Avista and similar-risk companies is 9.8%. Exhibit 50, p. 40, l. 12.

42. Although long-term interest rates have declined since the time when Dr. Avera prepared his direct Testimony, he did not update his analysis Tr.378:5-8. However, Public Counsel witness Hill showed in Exhibit 261, 82 that, using the same DCF inputs relied on by Dr. Avera, and relying on the very highest published earnings growth rates for those companies, an updated DCF result for his sample group of similar-risk electrics would be 9.3%, not 9.8%. Tr. 379:17-380:21.

43. Public Counsel also showed that if Dr. Avera's risk premium analyses are based on current bond yields they also result in cost of equity estimates that approximate 9.5% adding additional support to Public Counsel's position that the settled ROE, 10.4%, is too high. Exhibit 261, pp. xx,xx,xx) In reporting his higher risk premium results in his direct testimony, however, Dr. Avera used projected bond yields, a procedure that he has not used in the past. Tr. 386:11-24. Dr. Avera changed his risk premium cost of equity estimation procedure and the result of that change was to increase the cost of capital estimate produced. Tr.386:25-387:10. Dr. Avera has also changed his cost of capital analysis in other ways. For example, he now uses a different DCF model than he used in the past before this Commission and he elected to include a CAPM model analysis in this testimony while having omitted that methodology in the past. Tr. 381:17-383:24, 385:3-15. While Dr. Avera admitted methodological changes under cross-examination, he chose not to discuss the reasons for those changes in his written testimony. His election to use projected bond yields in this case for the first time results in a higher cost of equity estimate. The lack of a consistent methodology calls into question the reliability of Dr. Avera's equity cost estimates.

B. The Ratemaking Capital Structure Is Not Based On Avista's Consolidated Capital Structure.

44. The percentages of equity and debt in the ratemaking capital structure included in the Settlement Agreement, Exhibit 2, p.3, are virtually the same as those Public Counsel

recommended for ratemaking purposes as reasonable. However, Dr. Avera has claimed that because when investors buy a share of Avista they are buying the consolidated (regulated utility and unregulated energy trading) operations, only the consolidated capital structure is relevant for utility ratesetting. Tr. 400:15-24. Public Counsel strongly disagrees that Avista's consolidated capital structure is "the relevant" capital structure for ratemaking purposes.

45. First, when an investor buys a share of Avista they are aware that they are buying a portfolio of operations. The Company itself takes great care to point out on page 1 of their annual report to the Securities and Exchange Commission that one third of their equity is invested in an unregulated energy trading Company and two thirds of Avista's equity is invested in the utility operation. Tr. 397:4-11.

46. Second, all of the debt appearing on Avista's balance sheet is utility debt Tr. 399:1-6. Therefore, it is clear to investors that the capital structure supporting the utility assets is much more heavily leveraged (contains more debt and less equity) than the consolidated capital structure.

47. Third, the capital structure recommended by Public Counsel is based on the utility-only capital structure, but contains more equity and less debt than actual levels in order to support the financial health of the Company. It is only a coincidence that the 40% common equity ratio recommended by Public Counsel is similar to the consolidated capital structure of Avista.

48. Fourth, Public Counsel witness Hill notes that if Avista Utilities were properly capitalized with about 40% common equity, the consolidated Avista capital structure common equity ratio would be approximately 50% of total capital. Certainly, it would not be appropriate in that instance to set rates for Avista Utilities with the consolidated capital structure, just as it is not appropriate in the current proceeding.

49. Accordingly, it is important that the Commission in this proceeding make the determination that only the capital that supports utility assets—not the consolidated capital structure—deserves ratemaking consideration. Although that finding will make virtually no

difference in the ultimate rate determined to be necessary in this proceeding, it will make a difference in the future when Avista Utilities is appropriately capitalized and Avista's consolidated capital structure will be too equity-rich for ratemaking purposes. It is also important because it is a justification the need for an effective equity building mechanism.

50. Dr. Avera claimed at the hearing that setting rates for Avista Utilities with a capital structure that contains 40% common equity does not represent a rate payer subsidy. His position depends entirely on the Company's insistence that the consolidated capital structure of Avista's regulated and unregulated operations happens also to consist of about 40% common equity. Tr. 400:15-24 However, as Public Counsel shows definitively in Exhibit 278, pp. 7 and 8, when the actual capital supporting Avista's regulated utility operations is considered, the utility's common equity ratio is only about 30% of total capital. Therefore, providing an equity return on an additional 10% of equity capital the utility does not have in order to support its financial position (as recommended by Public Counsel witness Hill) will cost rate payers an additional $5.3 Million every year. That is a substantial rate payer subsidy of the Company's financial position. Avista and Dr. Avera cannot have their cake and it too. By agreeing to an equity building mechanism, the Company effectively admits that the actual capital structure supporting utility operations contains a level of common equity that is not sufficient to support the Company's financial soundness.

C. There Is No Basis for Using a Weaker Equity Building Mechanism Here Than in the PSE Case.

51. The Joint Direct indicates that Avista Utilities agrees to reach a common equity ratio of 35% by December 2007 and 38% by December 2008. Exhibit 1, p. 12. The common equity ratio targets recommended by Public Counsel are slightly higher than those included in the settlement (36% in 2007 and 39% in 2008). Public Counsel also recommends a target equity percentage at the end of 2006, which the Settlement does not. Finally, if the equity targets are not met, Public Counsel recommends a revenue reduction penalty of 2% of revenues, double the 1% in the settlement. Public Counsel's targets and penalty levels are patterned after the Commission's

order adopting a settlement PSE's 2001 interim rate case. *WUTC v. PSE*, Docket Nos. UE-011570 and UG-011571, Ninth Supplemental Order, Appendix A (Settlement Stipulation), p. 6.

52. Rate payers, who are currently being asked to provide financial support to Avista through the subsidy described above, would be better served by having regular step-wise common equity ratio targets for the Company to meet. That would include an improved common equity ratio by the end of 2006. An equity ratio of 33% by year-end 2006 would be reasonable in that regard.

53. In addition, the Public Counsel's 36% and 39% equity ratio targets go further than those contained in the settlement toward getting the utility to a point where the rate payers will be paying for the actual levels of common equity that finance utility plant, not hypothetical levels.

54. It is important to understand also that improving Avista Utilities' common equity ratio is beneficial to the Company and its investors as well as to rate payers. The utility will be on firmer financial footing and it will have a much better opportunity to improve its bond rating and lower its debt costs. Therefore, it is reasonable to subject Avista to the same rate penalty risk as was assigned Puget when the Commission ordered that Company to rebalance its capital structure. The two percent across-the-board rate reduction penalty was never incurred by Puget and its capital structure ratio targets were met early. There is no reason for the Commission to "soft-pedal" its approach with Avista by utilizing penalties only half as large. The risk/reward framework included in the Puget recapitalization plan worked very well. The Commission should continue to rely on a ratemaking strategy that has been successful in the past.

55. Finally, because the Company elected to raise its dividend payout three times within seven quarters between September 2003 and March 2005, and because increasing dividend payouts retards retained earnings growth at Avista, Public Counsel recommends that the Commission require the Company to freeze dividends at the current level until the common equity ratio targets are met. At the very least, concern over Avista management's dividend policy should provide the Commission additional incentive to maintain the 2% rate penalty requirement. This will mean that, if Avista Corporation management elects to pay out more of

its earnings in lieu of meeting is utility capital structure targets, it will do so to its own detriment. The Company should have sufficient incentive to meet those utility equity ratio targets.

IV. REVENUE REQUIREMENT ISSUES

A. Adjustments Required by the Matching Principle.

56. The matching principle is the principle that requires maintaining the relationship between rate base and net operating income consistent with the period of time chosen. Adherence to the matching principle insures that a relationship between the net operating income and rate base can produce a rate of return that is meaningful. The principle dictates that all cost-of-service components – revenue, investment, expenses and cost of capital --- should be considered and evaluated at a similar point in time. Exhibit 281, p. 15, ll. 1-11 (Lott Direct). Several of the Avista adjustments incorporated in the settlement violate this principle.

1. Production Property adjustment.

a. Matching.

57. Mr. Lott describes the calculations necessary for this adjustment in detail. Exhibit 281, pp. 23-24. In summary, he matches the pro forma production rate base with the pro forma operating income included in the case. He points out how Avista is making a one-sided adjustment by simply proforming a new plant such as Coyote Springs without analyzing all offsetting factors. Absent this adjustment, the Commission will overstate on a unit basis the fixed costs associated with the production plant.

b. The Production Property adjustment does not result in "double counting."

58. This point was raised by Avista as a major criticism of Mr. Lott's analysis on this issue. Avista attempts to misdirect the Commission by implying that Mr. Lott's proposed production property adjustment and the ERM retail revenue credit do the same thing, resulting in "double dipping." Witnesses Norwood and Parvinen repeated this concern on the witness stand in answer to Commission questions. Unfortunately, these assertions seem to betray a misunderstanding of the issue, and Public Counsel emphatically disagrees.

59. The key point is that Mr. Lott is recommending a set of changes to Avista's ERM that will bring it into line with the PSE mechanism, which Public Counsel supports. PSE uses both a production property adjustment to set rates, as well as incorporating a mechanism in its PCA that performs the function of the retail revenue credit factor. They are not mutually exclusive and perform different tasks. They do not double count. Mr. Lott's recommendation must be understood in the context of his recommendation of overall reform of Avista's ERM.

60. Defining the difference between the adjustment and the credit starts with the simple proposition that the production property adjustment is an adjustment which is intended to and, indeed, is necessary set general rates correctly. This adjustment, similar to all other proforma adjustments, attempts to set rates during the rate year at a fair just and reasonable level. Like the example of the fuel adjustment discussed with Mr. Parvinen, Tr. 180:1-12, if one does not make this adjustment, base rates are set at a unit cost which is too high. Moreover, as Mr. Parvinen agreed, in order to establish a PCA or ERM, leaving out the adjustment results in an asymmetrical mechanism. Tr. 180:13-15. The first step in creating a balanced PCA is to accurately set baseline rates.

61. Mr. Norwood agreed in both written testimony and cross that Mr. Lott is correct about the function of the production property adjustment. Exhibit 11, p. 8, l. 1- p. 9, l. 2 (Norwood Rebuttal); Tr. 238:19-25. Mr. Norwood's further point, however, that use of the retail revenue credit precludes the use of the production property adjustment, is simply incorrect.

62. The ERM, and all of its parts including the retail revenue credit, do not set general rates nor in any way determine what the fair, just and reasonable rate is. Rather, it is a deferral mechanism which is designed to be centered around rates that have been determined, as an initial matter, to be fair just and reasonable. Unless the production property adjustment is applied, the general rates are not being set at a rate that is fair just and reasonable. The inclusion of this factor solely in the retail revenue credit does not guarantee the rate payers any portion of what, in actuality, is a required adjustment in the ratemaking process. This is because, under the ERM,

the rate payers get no benefit at all from the retail revenue credit (and hence the production property adjustment) unless the deferral calculation exceeds the dead band. Even then the rate payers would only get 90% of the credit. Mr. Norwood agreed that all these costs would go through the sharing mechanism. Tr. 243:16-245:1.

63. In other words, under Avista's approach, rates are to be set at a level excessive by definition, because the production property adjustment is not taken into account. The problem is only remedied by the revenue credit if the deadband is exceeded. Even then, due to the 90/10 sharing band, the credit is only partial and customers never receive the full benefit of the adjustment.

64. In Washington, power cost adjustment mechanisms are intended to cover uncontrollable fluctuations in power costs from the base normalized level of rate making. PCAs are neither intended nor designed to return what should already be included in rates. The weakness in the Avista argument is exposed by an analysis of the PSE PCA which includes the equivalent of a revenue credit factor, while building on base rates that incorporate a production property adjustment.

65. As explained by Mr. Lott, both the ERM and the Puget PCA deal with fixed cost, though not in identical fashion. Avista's ERM starts by comparing authorized power costs to actual power costs on a nominal basis. Then, because load may grow or shrink, a revenue credit based on a unit cost including fixed and variable costs is applied. In this way the actual and authorized variable costs are converted to a unit cost comparison.

66. With respect to fixed costs, the calculation of the retail revenue credit in essence subtracts the revenue generated by growth for the fixed costs from the total. In this fashion fixed costs are limited to the level included in the general rate case. In PSE's PCA this is done more directly. Actual unit costs from the rate case including fixed costs are compared to unit costs from the deferral period. The calculated unit costs from the deferral period include actual variable costs, (e.g. the treatment of fuel and purchased power). In addition, the fixed costs are held constant at

the test year level with one exception. That exception is the reversal of the production factor adjustment. While Avista is concerned that the production adjustment would duplicate the retail revenue credit, that is not how it is treated in the PSE PCA.

67. Only PSE has a fully developed PCA. Mr. Lott's testimony recommends changes to the ERM to make it achieve the same goal. PSE's PCA has both a production adjustment in the general ratemaking process and a mechanism basically identical to the retail revenue credit factor in the ERM. There has never been a suggestion that this is double counting. The reason is that there is specific treatment in the PCA for the production adjustment.

68. As demonstrated in the cross-examination of Mr. Parvinen, the production adjustment is treated as variable costs in the calculation of actual costs in the PSE PCA. Tr. 181-185; Exhibit 362. This is accomplished by adjusting each of the fixed nominal costs in the PCA by the production adjustment, if applicable. Mr. Parvinen confirmed that each of the production fixed items was adjusted upwards while the transmission costs which were not included in the production adjustment were not adjusted. Tr. 181-185. In this way the known and measurable rate year costs are held constant. This is identical to the treatment in Avista's ERM, except that in the Avista case the rate year level of costs is included in the general rate case. Thus, in Avista's case the rate payers would not receive the benefit of the $2.4 million adjustment before the ERM mechanism begins.

69. Mr. Parvinen testified that a production property adjustment of this type has been in use by PSE in virtually every rate case in his years at the Commission. Tr. 181:15-21. Mr. Norwood also acknowledged that PSE uses a production property adjustment in conjunction with its PCA. Tr. 239-241.

2. The Coyote Springs 2 and Transmission Project Adjustments.

70. Mr. Lott also proposed two other adjustments related to the matching principle: the Coyote Springs 2 adjustment and the Transmission Project adjustment. Mr. Falkner proformed these large plant additions using varying methods. Exhibits 113, 114.

71. Review of these cross-examination exhibits reveals that Mr. Falkner did not proforma any of these plant additions to the rate year 2006 level nor were the additions pro formed into rates that would be in place during the first year of service. For Coyote Springs 2, Mr. Falkner does not use the first year of deferred taxes as the plant was added after the beginning of the year and a portion of second year taxes is appropriate. The deferred taxes in his calculation understate the 2005 level because too much book depreciation is subtracted. Thus, the deferred tax level included in Mr. Falkner's adjustment will never actually come to pass.

72. The adjustment of transmission plant was done differently. Here Mr. Falkner gives effect to the second year of tax depreciation but fully ignores the first year of tax depreciation. Mr. Lott, on the other hand, was consistent with his adjustments. He calculated the plant-in-service accumulated depreciation and deferred taxes based on what will be experienced during the first rate year 2006. Further, unlike the Company and Staff, Mr. Lott followed the tax regulations which require that, when a projection of plant is made beyond the historical test year, plant-in-service, depreciation and deferred taxes must all be calculated on the same average.

73. The point here is that in this proceeding Avista is adding plant that was not used in the test period, was not necessary in the test year, and is only necessary for future periods. Tr. 700:24-702:8. Public Counsel does not object to inclusion of this plant per se, but if included, it is essential that the pro forma calculation should be based on the proforma level of expense to be incurred in the rate year. This is how wages and most other cost items are pro formed and the same should be true for plant.

3. Colstrip Upgrades.

74. The Company ignores the upgrades of the Colstrip plants identified in Mr. Falkenberg's testimony. Exhibit 301C. This exhibit shows that the upgrades to both Colstrip 3 and Colstrip 4 will produce substantial benefits in relationship to their cost. *See also*, Exhibit 287C, p. 6, ll. 5-6 (Lott Rebuttal). Avista does not incorporate these in its case, arguing that the upgrades are not complete. Exhibit 174, p. 20, ll. 18-22. As noted above, this argument has not stopped Avista

from proforming transmission property that is not complete as of today, where such additions add to the revenue requirement and support a rate increase. Similarly, in the last general rate case this argument did not prevent Avista from including the first half of Coyote Springs 2 in rates in July 2002 although the plant was not added to plant-in-service until July 2003. Exhibit 146, Tr. 696:23-697:4. Here, where the Colstrip upgrades increase rate base but decrease revenue requirements, Avista excludes them from the calculation.

75. Mr. Falkenberg included all the Colstrip upgrade benefits. Mr. Lott took a somewhat more conservative approach and included only half the investment, as explained in his confidential rebuttal testimony. Exhibit 287C, pp. 6-7. Mr. Lott's adjustment represents the benefits the Company will be able to experience during the rate year.

B. Normalization Adjustments.

76. Public Counsel challenges a number of Avista's adjustments because of the Company's inconsistent use of normalization methodology. This issue is explained in detail in Mr. Lott's direct, Exhibit 281, pp. 39-42. The fundamental point, however, is that Avista appears to vary its choice of normalization periods and methods so as to achieve the most favorable outcome for the Company's case (i.e. to minimize revenues, or accentuate expenses) and increase its revenue requirement. The settlement has not addressed this problem. Staff apparently did not have full information about these adjustments until after agreeing to settle the case. Tr. 188:23-189:5 (Parvinen). This section highlights several of these issues.

1. Open Access Same Time Information System (OASIS) Revenues.

77. Both Avista's original case and the settlement incorporate an unreasonably low level of revenues for this item. In its initial filing, Avista proposed reducing OASIS system revenues by nearly $4 million, a more than 72% reduction in test year revenues for this item. Avista did not supply in its filing either testimony or work papers supporting this adjustment. In response to Mr. Lott's inquiries on the issue to the Company and the Staff, Staff requested that Avista supply support for the OASIS adjustment. Avista provided a FAX to Staff on July 25 with a one

sentence explanation of the adjustment. Exhibit 116, p. 3. The description provided states only that "[r]evenue for Oasis has been revised down from $5,475,000 to $1,500,000 based on a projected lower level of third party transmission usage and revenues anticipated in the rate period primarily due to BPA transmission additions." No work paper supporting Avista's original calculation was submitted.

78. During and subsequent to the settlement, in a data request response dated August 22, Avista supplied additional information concerning the OASIS adjustment. Exhibits 117 and 122C.[3] The test year OASIS revenue was $5.4 million, while the five year average (2000-2004) is $4.4 million. The three year average (2002-2004) is $4.2 million, with calendar year 2000 experiencing the lowest OASIS revenues with $2.4 million. Exhibit 281, p. 45, ll. 20-22 (Lott Direct). Exhibit 117, p. 1 states: "The Company believes that 2001 was an anomaly and should not be used for future revenue forecasts since the energy crisis observed was an extraordinary event." This document thus argues against use of a five year average (2000-2004).

79. Avista has elsewhere argued that 2004 is abnormal. Exhibit 117. Instead of using the remaining three years as an average, however, Avista essentially discards all of the years and determines a normalized level of $2.4 million based on the unaudited first six months of 2005. Exhibit 117, p. 4. Neither Staff nor any other party has had a chance to audit this data. However, even a cursory review of Exhibit 117 indicates that while January, February, and June are in line or higher than the year 2004, April and May are the two lowest months of the entire five years shown on this schedule. The use of only an unaudited six months period like this is not a standard or appropriate method to proforma any cost, particularly when the data appears to contain such abnormal amounts.

80. As a result of the Avista/Staff approach, the settlement includes system level OASIS revenues (non firm and short term sales) of $2.4 million which is equal to or lower than the lowest of any of the five years (2000-2004). *Cf.* Exhibit 117, p. 4 and Exhibit 122C, p. 2.

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[3] Note that the two exhibits reflect substantially different amounts for the annual revenue for the year 2000. Counsel for Avista has advised that annual totals and averages from these exhibits are not confidential.

81. Public Counsel's proposed adjustment is more reasonable. Mr. Lott excluded the two highest historical years (2001 and 2004) from the average as being abnormal, consistent with Avista's testimony. He proposes to include $3.2 million of OASIS Revenues by considering a three-year average of remaining "normal" years. His adjustment combines the settlement OASIS revenue of $860,000 from Exhibit 284, p. 1, and the additional Public Counsel adjustment of $831,000 in Exhibit 285 and 290. The balance in Public Counsel's recommendation is shown by the fact that Mr. Lott's proposed adjustment of $3.2 million is still lower than all of the years on the schedule excluding 2000. Indeed, if the figure for 2000 revenue in Exhibit 122C, p. 2, had been utilized Mr. Lott could have supported a higher amount.

2. Wheeling for System Sales and Purchases; Broker Fees.

The normalization issue here is that the Company used a five year average despite the fact that the first two years of the period, during the energy crisis, had sales three and seven times greater than any other year and purchases two and four times greater, respectively. Exhibit 193. Mr. Lott performed an analysis of the relationship and determined that this expense item directly correlated with the total level of sales and purchases. Exhibit 281, p. 47. Based on that relationship and the level of sales and purchases included in Mr. Kalich's model run, Mr. Lott calculated a pro forma level consistent with those sales and purchases. *Id.*, p. 26, l. 20-p. 49, l. 12.

82. The basic point here is that these transactions should produce a net benefit to the Company beyond what is included within its pro forma power supply adjustment in this case. If it is appropriate to include these additional costs, then it is also appropriate and equitable to include the net benefit from undertaking the transaction that the extra costs are intended to generate. In this case Avista only wants to add the expense of engaging in secondary sales and purchases, but wants to keep the benefits derived from such activities. [4]

[4] Mr. Lott also proposes that these costs and broker fees are direct variable costs and should be included in the ERM, consistent with the PSE PCA. See ERM section below.

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83. It is also significant to note the inaccuracy of Mr. Johnson's statement that these expenses are incurred to bring power from the Mid-Columbia to Avista's system. As shown in the cross-examination of Mr. Johnson, these wheeling expenses are related for the most part to transmission expenses incurred to deliver power or receive power from six large utilities west of the Cascades. Exhibit 195; Tr. 635:22-636:7. A majority of the test year total was paid to Snohomish County PUD. *Id.*

3. PPL Dry Gulch Revenues.

84. Mr. Lott's rebuttal explains that while the Company claims it used a five year average on this item, it appears to in fact have used a three year average, which it then escalated. Avista proposes a level of revenue essentially equal to the lowest amount in the last five years, again, an outcome that suppresses the Company's revenue level. Mr. Parvinen testified that the method used by Avista is incorrect. Tr. 190:5-16.

4. Transmission Expense for Garrison-Burke.

85. This item again highlights the dangers in utilizing the varying normalization periods for each account. On the revenue side (e.g. for OASIS revenue), Avista has argued that 2001 was abnormal and did not believe that including this "high year" experience in the normalization process was fair. By contrast, on the expense side, for items such as Garrison-Burke, Avista wants to use all five years of available data in the average. For this item, 2004 was the lowest of the last five years by over 26% from the 2000 level, and 31% less than calendar year 2002, the next lowest year.

86. There are at least three issues with Avista's calculation. First, as shown in Mr. Johnson's workpaper P95, Exhibit 196, the year 2001 is 80% higher than any other year and nearly three times higher than the test year. Second, 2001 included substantial purchases of firm transmission, which would be consistent with Avista's statements concerning 2001 OASIS revenues.

87. Third, there is no documented support for Mr. Johnson's contention in rebuttal testimony that firm transmission purchases are included in this account. Exhibit 186, p. 11, l. 19. A month by month review of the 2004 invoices shows that they were all for non-firm purchases. Review of 2002 and 2003 invoices in Exhibit 198 show no firm purchases and total invoice amounts equal to or greater than the annual amounts shown in Johnson Workpaper P 95. Exhibit 196. On cross- examination, it was shown that firm purchases were not documented for a number of months. Tr. 639:12-641:5, 642:9-17. Mr. Johnson testified that Avista was nevertheless charged for the transmission but that there were no invoices or other record from the other utilities of their billing.

88. To be consistent with the approach to the OASIS revenues adjustment, Mr. Lott excluded the abnormal number from 2001 and the 2000 numbers for which Public Counsel was unable to obtain the invoices to verify these amounts. Exhibit 281, p. 52.

C. Third Party Unsupported Budgets.

89. Two of the adjustments supported by Mr. Lott, Wanapum and Colstrip 500KV transmission, have to do with unsupported budgets of third parties. Exhibit 281, pp. 49-51 (Wanapum), pp. 56-57 (Colstrip). In both of these cases, by contract, Avista is responsible at the end of the year for only the actual expense it incurs, and not the budgeted amounts. Neither of these adjustments are appropriate pro forma adjustments under the Commission's "known and measurable" standard. Further, because of the reliance on third party budgets, there are no witnesses to cross examine on the validity of these projections.

90. For Wanapum, Avista utilized Grant County PUD's "unofficial" Power Cost forecast. Exhibit 281, p. 50, ll. 11-13. The O and M expense for 2006 shown on this exhibit is represented by a single number. This sheet, a forecast apparently done by Grant County prior to the end of 2004, is unsupported by any documentation, workpapers or explanations of any kind explaining why the Wanapum O and M forecasts would increase by over 24% from 2004 to

2006. This "unofficial" projection does not represent a "known and measurable" amount of O and M expenses for Wanapum.

91. On the transmission expenses for the Colstrip 500KV line, Avista is again apparently relying on a budget from a third party. The only support for this 18% increase over test year levels was provided in the transmission workpapers sent July 25th to Staff, stating: "The Colstrip expense has been revised from 262,000 to 310,000 based on budget information from Northwestern." Exhibit 116. No actual budget was included explaining the increase.

92. Apparently Exhibit 294, entered as a cross-examination exhibit for Mr. Lott is the Company's attempt to support this budget amount. This limited documentation was received in October on the eve of hearing. Other than what is included in the document, the exhibit includes no workpapers or explanations of causes for the increases or how the numbers are derived. This is not a proper known and measurable adjustment and should be rejected.

D. Rathdrum Lease.

1. Avista's calculation of this pro forma monthly lease payment uses an improperly high interest rate.

93. During the last 10 years Avista has incurred a lease expense for the Rathdrum facility, a combustion turbine power plant in Rathdrum, Idaho. While this lease meets the requirements for capitalization under generally accepted accounting principles, the lease was held by an unconsolidated subsidiary. For ratemaking purposes the lease payments have been treated as an operating expense. Those payments to date have only covered the interest cost of the lease, while the total cost of the plant (i.e., the "principal" portion) remains to be amortized for ratemaking purposes. Exhibit 281, p. 52 (Lott Direct).

94. In this case the Company initially pointed out that the lease was entering a new stage in 2005, and at the expiration of the current lease agreement Avista would have to make lease payments which included both the interest and the principal portion of the financial lease. Based on this fact the Company prepared an amortization schedule for the remaining balance of $56,260,000 using 173 monthly payments and an annual interest rate of 8.3629%. Avista's pro

forma monthly lease payment, based on this schedule, was $560,721, resulting in an annual increase in costs of over $2 Million. *Id.*, p. 53.

95. Mr. Lott's testimony, and the cross-examination in this case indicate that the anticipated interest for this lease, including administrative charges and equity markups, was only 6.85%, not the 8.365 used by Avista. Exhibit 281, p. 53, ll. 7-21; Exhibits 199-201; Tr. 655:13-19. Using this interest rate results in a monthly lease payment of only $512,646, a reduction in annual cost of $577,000 on a system basis from that proposed by Avista. This is the adjustment Mr. Lott proposes on behalf of Public Counsel in this proceeding.

2. It is not clear that the termination of the Rathdrum lease is in the ratepayers' best interests.

96. The interest rate discussion above is not the end of the story. The question taken to the Board of Directors does not answer whether the termination of the lease is in the best interest of Avista Utilities rate payers. As shown on cross-examination, in Mr. Johnson's Exhibit 187, Tr. 654:15-23, the calculation of revenue requirement for Rathdrum is not the 5.90 % debt cost included in the justification to the board but rather the overall return of 9.11%. Avista's proposal is to leave Mr. Johnson's erroneous calculation in the pro forma because it represents a lower revenue requirement than would be the case if Rathdrum was placed in the rate base. There is no evidence, however, that the termination of the lease is in the best interest of the rate payers. The Company proposal requires the rate payers to pay in excess of what they would have paid if the lease had continued, without any support as to the prudence of this action.

97. If the benefits of reducing this debt cost are in fact passed through to the rate payers it would appear that this would benefit the rate payers in the long run. There is the problem testified to by Mr. Hill, however, that the capital structure being proposed in this case for Avista Utilities is hypothetical. If this lower cost debt is added to Avista Utilities it will lower the overall cost of capital for the utility even further. There is no proposal in this case to reflect the anticipated but as yet unissued debt financing. It would be imprudent for Avista Utilities to

change its method of financing Rathdrum if, as a result, there is a long term negative impact to the rate payers.

98. If we assume that in a future proceeding Avista can demonstrate that it is in the rate payers' best interest to traditionally finance and rate base a facility previously leased, Mr. Lott recommends it would be appropriate to undertake steps at this time that would protect Avista from being harmed by the move to capitalize the currently leased plant. In order to protect Avista, the Commission could simply provide them an accounting order allowing them to amortize the plant using a present value schedule consistent with the principal portion of Mr. Lott'slease payment schedule. Under this scenario, if the change in financing results in a true and quantifiable reduction in debt cost as claimed by Avista, then the Company would be able to reap the benefits between now and the next case of these reduced debt costs. Exhibit 281, pp. 54-55 (Lott Direct).

E. Kettle Falls Fuel.

99. Mr. Lott's recommended adjustment for Kettle Falls fuel is discussed in detail in Exhibit 281, pp. 42-45. Mr. Lott's calculations are even-handed, proposing to increase the price and the conversion rate from the Company's original filing thereby increasing the proforma level of cost by approximately $700,000. Ultimately, however, the Company went even further and pushed the conversion factor higher, increasing costs by $437,000. It also appears that Avista chose to use an average that included a year that did not have normal burns at Kettle Falls. *Id.*, p. 45.

F. Kettle Falls Disallowance.

100. If the Commission allows the Avista calculation of this item to stand, the Commission will be allowing a portion of the Kettle Falls plant in rates that was previously determined to be imprudent and not the responsibility of rate payers. Exhibit 281, p. 13 (Lott Direct). This issue has been contested twice, in general rate proceeding U-83-26 and in U-84-28. In the first, U-83-26, the Commission specifically stated that only $80,555,706 of the total $89,299,000 would be allowed for rates prior to allocation. U-83-26, Fifth Supplemental Order, p. 16. Later, in U-84-

28, the only other time this adjustment was contested, the Commission again found for Staff and disallowed 9.88 % based on the total net investment in the plant on the basis that the Company had not demonstrated that its investment was entirely prudent. Mr. Lott calculates this adjustment in the only fashion consistent with the Commission orders, i.e., calculating the total disallowance of the plant and then allocating it to Washington. Avista's approach would result in imprudent costs being included in Washington rate base in violation of both of these orders. *See generally,* Exhibit 281, pp. 10-13 (Lott Direct). Here Staff has apparently agreed to an adjustment clearly at odds with past Commission treatment of this disallowance, and Staff's past advocacy.

G. Hydro Shaping.

101. Public Counsel, through the testimony of Mr. Lott, supports ICNU witness Falkenberg on this issue. In summary, Avista has a resource for which the level of generation is normalized over a 40 to 60 year period. The Company has some control over when that resource will be utilized. As noted by Mr. Falkenberg, it is essential that the utilization be pro formed in a fashion consistent with real world efforts to minimize costs as opposed to a rigid mechanical schedule that does not match an appropriate decision making process. Exhibit No. 301C, p. 30. Further, the Company's calculation of this mechanical schedule uses a normalization technique that matches total normal water with shaping from substantially below average water. The Commission should adopt Mr. Falkenberg's alternative approach. Exhibit 287, pp. 3-5 (Lott Rebuttal).

H. Additional Adjustments.

102. Public Counsel recommended several additional adjustments in the testimony of James Dittmer, Exhibits 231-237. Mr. Dittmer's adjustments for Sale of California Gas Property, Exhibit 231, p. 14. and Vegetation Management, Exhibit 231, p. 26, remain in dispute. Public Counsel's evidence on these adjustments casts further doubt on the validity of the settlement revenue requirement.

V. ENERGY RECOVERY MECHANISM (ERM)

A. Public Counsel Offers a Superior Recommendation to Reform Avista's ERM.

103. Public Counsel, in testimony of Mr. Lott, makes a detailed set of recommendations designed to transform Avista's ERM into a properly designed power cost adjustment mechanism. Exhibit 281, pp. 74-81. Public Counsel's testimony also provides, *inter alia*, a description of the current ERM, a history of Commission decisions and guidance on power cost adjustment mechanisms, and a critique of Avista's initial proposal. *Id.*, pp. 57-74.

104. In summary, Public Counsel proposes three areas of adjustment to the ERM:

- the inclusion of all appropriate power costs;
- modification of the variable cost category (bucket) to remove "general rate case" type items and add other items that vary directly with short term events;
- revise the sharing bands, including the dead band. *Id.*, p. 74.

105. Public Counsel's proposal for three-tiered sharing bands would create a "deadband" of $6 million, a 50/50 sharing band for the next $6 million, and a 90/10 sharing band for the remaining amounts above $12 million.

106. In order to avoid rate shock, Public Counsel only recommends a surcharge to retire the existing deferral in the context of a revenue requirement at the lower levels recommended by Public Counsel and ICNU. *Id.*, pp. 79-81.

107. Public Counsel proposes changes to the ERM that could be adopted by the end of the year, including changes to the sharing bands. If the Commission decides not to direct that these changes be made to establish a new PCA for Avista, the ERM mechanism is up for review in 2006. Until such time as a comprehensive reform is adopted to be in compliance with the guidance of this Commission and the criteria identified in Public Counsel's testimony, the existing ERM should remain in place. Changing the dead band or the sharing bands now in isolation, absent a comprehensive change of the mechanism simply shifts an unwarranted level of risk to rate payers with no compensating benefit.

108. Specifically, if the Commission decides not to accept Public Counsel's recommendations for detailed revisions to the ERM at this time, Public Counsel recommends: (1) require the $9 million deadband to remain in place on a temporary basis; (2) direct Avista to recalculate the revenue credit factor according to the existing ERM requirements, and (3) order the parties to immediately enter discussions to modify the ERM to be consistent with the principles adopted by the Commission for power cost adjustment mechanisms.

B. The ERM Provisions in the Settlement Should Be Rejected.

1. The ERM settlement is not consistent with Commission guidance on power cost adjustment mechanisms and improperly shifts risk to ratepayers.

109. The principles identified by Mr. Lott in his testimony are derived from the past decisions of the Commission which provide well-established guidance for the proper structuring of power cost adjustment mechanisms. The Commission has announced three broad policy goals: (1) a power cost adjustment mechanism should be linked to factors that are weather related; (2) a power cost adjustment should be a short-run accounting procedure that reflects the short-run cost changes affected by unusual weather, whereas the prudency of long run resources is the proper subject for a general rate case; and (3) where a PCA is established, rate payers 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 pp. 13-15; *WUTC v. Washington Water Power*, Docket No. U - 89-2363-P, First Supplemental Order, p. 8. Mr. Lott's direct testimony discusses this guidance extensively along with the six corollary criteria derived from Commission precedent in this area. Exhibit 281, pp. 62-65.

110. Mr. Norwood attempts to minimize the importance of these precedents by referring to them as dated. Exhibit 11, p. 14, line 7. None of these decisions has been reversed, however. He suggests that the energy crisis of 2000-2001 has rendered them less relevant, overlooking the fact that PSE's current PCA was adopted in their 2001 rate case. *Id.*, p. 14. Moreover, in Avista's 1999 general rate case decision in 2000, the Commission reaffirmed the policy goals set out above. *WUTC v. Avista*, UE-991606, UG-991607, Third Supplemental Order, ¶¶ 169-172

(see generally ¶¶ 167-185). Interestingly, in that case, Staff strongly opposed Avista's proposal because it was not consistent with the Commission guidelines and improperly shifted risk to consumers. *Id.*, ¶¶ 168-174. Consistent with the Staff, Public Counsel and ICNU recommendations in that case, the Commission rejected the Avista PCA proposal, stating:

> As we have already noted, such proposals must include an equitable balancing of risk between rate payers and shareholders. *Mechanisms that simply shift risk from shareholders to rate payers without compensating benefits do not meet this objective.*

Id. ¶ 185. (emphasis added).

The ERM settlement in this case, by reducing the deadband without any other modifications, unequivocally shifts risk from shareholders to rate payers without a compensating benefit. As such, it directly violates the Commission's direction. The Joint Direct Testimony in support of the settlement is silent on this issue of risk shifting and on cross-examination, Mr. Braden for Staff seemed unwilling to acknowledge or address it, preferring to talk about possible benefits to customers from reducing the deadband. Tr. 291:4-11. Unfortunately, by agreeing to this aspect of the settlement, Staff has departed from its own previously held position which supported the Commission's direction quoted above.

2. The settlement does not address important flaws in the current ERM.

111. The current ERM falls short of the Commission's guidelines in several areas. One primary flaw is that the ERM is not limited to recovering costs that vary because of weather or other uncontrollable items. The mechanism as currently designed allows all changes in the purchased power and fuel accounts to flow through the mechanism. For example, new contracts, changes in contract pricing, and fuel costs that are independent of a fluctuating market (such as coal) are all cost elements that are included within the mechanism but that should properly be reviewed in a general rate case. The problem is that these cost increases are included in the ERM calculation, while at the same time the mechanism holds production rate base at the

previous rate case level despite its steady trend downward, thus passing on unfairly inflated cost increases to rate payers. In order to be consistent with the Commission's guidance that a PCA should be a short run accounting procedure for short run cost changes, no long term cost increase items should be passed through the ERM. PSE's PCA properly excludes these cost increases and Public Counsel recommends that the ERM should as well. Public Counsel is aware of no justification for weakening the Commission's PCA standards when they are applied to Avista.

112. The Avista ERM has other problems. It also fails to look at the total costs of providing power, excluding, most notably, the transmission costs associated with generation and transmission revenue. Exhibit 281, p. 66 (Lott Direct). Further, it fails to reflect only power cost changes that are not under the control of the Company. *Id.*, p. 67. These issues are discussed in more detail in Mr. Lott's Direct Testimony. *Id.*, pp. 65-68.

3. The Settlement does not address Avista's hidden changes to the ERM.

113. The settlement in the case cites the deadband modification as the only change to the ERM. In fact, without mentioning it in testimony, the Company proposed a change in what was included in the ERM via the retail revenue credit factor. That change remains in the ERM, though not addressed in the settlement, as confirmed in the cross-examination of Mr. Parvinen, Tr. 186:4-7. Mr. Parvinen stated this issue was not "deemed significant enough to warrant dealing with it in the context of the settlement." Tr. 187:1-3. It is not clear if Staff was aware of the change or has ever measured it.

114. As shown in Ms. Knox' Rebuttal Testimony, Exhibit 136, pp. 7-8, if the retail revenue credit had remained at its prior level, the factor would be 3.739 cents per kWh, not 3.399 cents per kWh as filed in the Company's original case. The revised factor is 9.1% lower. In 2004, the revenue credit was $3.66 million. Multiplying that by 9.1% yields $333,000. Through September 2005 the revenue credit is $5.42 million. Calculating 9.1 % reduction of that figure yields $493,000. The effect on the retail revenue credit factor over two years, therefore, appears likely to approach $1 million, hardly an insignificant number. Assuming the load escalates as

projected by Avista, reducing the factor decreases the retail revenue credit thus increasing an under-recovery and lessening an over-recovery. In other words, it gives more dollars to the Avista shareholders.

VI. RATE SPREAD AND RATE DESIGN

A. The Commission Should Again Reject the Company's Cost of Service Study.

115. The purpose of a cost of service study is to apportion the utility's costs between the customer classes. It uses data on customer class usage, utility costs, and historical and prospective data to determine which customer class should bear what percentage of the total system cost.

116. To Public Counsel's knowledge, this Commission has never accepted an Avista cost of service study. The Commission has consistently rejected Avista's cost of service studies, and has regularly rejected rate spread proposals based on those flawed studies.

117. In the Company's last contested electric proceeding, in1999, the Commission had the unusual situation of a stipulation involving all parties except the Company on rate design issues. The order stated:

> As a general principle, the Commission agrees that it is reasonable to move each customer class toward the cost of providing it with service. *With a disputed cost of service study, however, we cannot take the Company's determination of "unity" as an absolute goal. This Commission has never mechanically applied the results of a cost of service study, but exercises judgment in each determination.* The Joint Testimony offers movement toward the Company's goal; it recommends larger than average decreases for commercial customers. We also note that ICNU, which represents large industrial customers, is a sponsor of the joint testimony; we give weight to its opinion of an appropriate spread of rates to industrial customers. The revenue requirement decrease as a result of this order should be spread according to the Joint Testimony's rate reduction formula. The problem with going further toward unity, as Avista urges, is that *Avista's underlying cost of service study is not sufficiently rigorous to rely on it* for that purpose at this time.

(UE-991606, *Third Supplemental Order*, p. 109)(emphasis added).

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118. The Company's electric cost of service study should again be rejected in this case. Here, the Company has used "peaking" resources to design its study that are not representative of the costs of peaking units shown in its own Integrated Resource Plan (IRP) study. It has included resources in the peaking category that are not really peaking units. It has used erroneous data on peak demands – drawing from all 12 months of the year, when the real peaking units are only used in a few months of the year.

119. Perhaps most important, the Company has completely ignored the biggest driver in its rate increases – load growth by some, but not all, customer classes that has forced the Company to acquire expensive new resources. Although the Company's residential and small commercial customers have had almost no load growth, Exhibits 163, 168, 144, the Company has assigned over half of the proposed increase to these classes. Meanwhile, the classes which have caused the overwhelming majority of the growth in sales (and therefore, growth in costs) have been assigned less than half of the increase. Exhibit 2, Settlement Agreement, Attachment C (Rate Spread).

1. The so-called "peaking" units used by Ms. Knox are non-representative of peaking costs.

120. The Company has mis-applied past Commission direction in applying the Peak Credit methodology for classification of production and transmission plant. The Peak Credit method assigns a portion of the cost of baseload power plants to the peaking capacity function, and the balance is assigned to the energy function. This allows high-cost baseload power plants to be appropriately assigned to the customer classes based on their use of the two products provided by these units – peaking capacity during extreme weather, plus baseload energy the rest of the year. In all past analyses, and indeed in the Company's IRP, peaking units are much less expensive to install than baseload units, but due to lower running costs, baseload units are appropriate where power is needed all year, not just during peak periods.

121. Ms. Knox used the costs of the Boulder Park and Kettle Falls combustion turbines as "peaking" units in her cost of service study. Exhibit 148 (Knox Workpaper TLK-59). The

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record shows that these units cost more than $1300 per kilowatt of capacity. *Id.* This is more than twice as much as the cost of a baseload unit such as Coyote Springs as shown in her own exhibit. Her proposal to define power plants as "peaking" that cost twice as much as "baseload" units defies the entire concept of the Peak Credit methodology, which she agreed assigns only a portion of baseload plant costs to the peak demand category. Tr. 338:16-339:1.

122. The Company's own IRP shows that peaking units are cheaper than baseload units. Exhibit 145. This is logical – if they were not, the Company would not build peaking units. Peaking units cost $400 to $600 per kilowatt. Exhibit 145. Rathdrum and Northeast are examples of lower-cost peaking units. Exhibit 148. This raises a significant question of whether the Boulder Park and Kettle Falls CTs are prudent investments at all, but at a minimum, they should not be classified as peaking units. Ms. Knox acknowledged on cross-examination that these units could be seen as more like "intermediate" generating units. Tr. 346:15-17. We agree. The dispatch records for these units show that they do not run like peaking units. Exhibit 142.

123. The evidence is clear that the Boulder Park and Kettle Falls Combustion Turbines (CTs) do not have the cost characteristics of peaking units, and do not have the operating history of peaking units. They are not peaking units. They should not be treated as peaking units in the cost of service study. The cost of service study is, therefore, fundamentally flawed.

2. The "12 monthly peak" method is not representative of the use of peaking units.

124. Ms. Knox has allocated those costs which are defined as peak demand related based on the average of twelve monthly peaks, taken from each month of the year. The 12 monthly peak method is not representative of the use of peaking units. Ms. Knox provided Exhibit 142 showing the dispatch of the various power plants, and it clearly shows that the real peaking units like Rathdrum and Northeast are only operated a few hours per year, during the peak months. Rathdrum had zero use during 8 months of 2004 with a capacity factor of 0.45%. Northeast had zero use in 9 months of 2004 with a capacity factor of 0.02% per year. The Commission has

previously considered and ruled on what hours should be used to define "peak" and has said that 200 hours per year – the highest 200 hours – is the right definition of peak. The Commission stated that: "The 200 hour proposal by the Company is reasonably representative of the system peak and the actual resources put into place to serve that peak." *WUTC v. PSE*, Docket No. UE-921262, Ninth Supplemental Order, p. 12.

125. The Company's dispatch of the real peaking units reflected in the Knox exhibit – no use at all during most of the months --- is consistent with the Commission's past rulings. The Company's use of non-representative power plants and non-peak periods to allocate those costs makes no sense at all. Avista does not build peaking power plants to serve loads in shoulder months like October. Tr.735:12-13 (Lazar).

126. The Washington Water Power Company, now known as Avista, was a party in Puget's 1992 rate proceeding, Docket UE 921262. It should know and understand both the Puget methodology and the reasons why it was approved. It should also understand why only one-half of the cost of peaking plants should be allocated based on peak demand – because they can be used to back up the hydro system in dry years. UE-921262, *Ninth Supplemental Order*, p. 9. Avista has more hydro than any of the other companies in Washington, and this logic is even more applicable to Avista than to Puget.

127. The Company's approach is inconsistent with its own IRP, inconsistent with past Commission decisions, and inappropriate for the Avista system. The cost of real peaking units is closer to $400 / kW. They are used only a few hours per year. The cost of service study should reflect reality. Unfortunately, the Company could not provide a study using the Commission-approved methodology, because it has not collected the data. Exhibit 160; Tr. 320:8-321:5 (Hirschkorn).

128. The Commission should direct the Company to develop load research based on the actual dispatch of the real peaking units – those that have low capital costs and low fixed O&M costs, plus peaking power purchase contracts used for the peak periods. If they are typically used 200

hours per year or so, the Company should use that actual dispatch history to determine the peak hours. In addition, since peaking units can also be used to back up the hydro system, only one-half of the cost of a true peaking unit should be deemed to be peak demand related. The Puget methodology – or one similar – should be required of Avista.

3. Differential growth between customer classes drives this case.

129. The record in this case is very clear. The residential class is not growing. It is not creating the need for the expensive new generating plants that are driving this rate case. To be clear, the Boulder Park, Kettle Falls CT, and Coyote Springs plants were built to serve growth. The classes that are growing, not the residential class, are creating the need for these new power plants. Exhibit 168, Tr. 312:3-314:10. (Hirschkorn). This is true for both peak and energy. Ms. Knox admitted that the residential class peak demand is "relatively stable," i.e., not appreciably growing. Exhibit 144, Tr. 336:9-12.

130. The evidence shows that Large and Extra Large General Service classes are causing the load growth. *Id.* They should bear the costs of the expensive new resources like Coyote. It is unfair to impose these costs on the residential and small general service classes when they did not cause the need, and when they are also facing huge increases for natural gas service. (see rate design discussion below).

4. The Commission should adopt Public Counsel's rate spread as proposed by Mr. Lazar.

131. The Commission has previously approved the use of the "range of reasonableness" approach used by Mr. Lazar – giving a uniform percentage increase to classes with a parity[5] ratio between 90% and 110%. U-84-65, Third Supplemental Order, p. 49.

132. Given that the Avista cost of service study is not acceptable, and that even that study shows that the residential and industrial class has the same parity ratio, there is no basis for applying a larger increase to the residential class. Mr. Lazar has proposed that both should get

[5] The "parity ratio" is the ratio of revenues at current rates to the revenues that would be needed to produce the system average rate of return for each class. For example, if current residential revenues were $95 million, and the revenues needed to produce the system average return were $100 million, that would be a 95% parity ratio.

the same increase. That is, indeed, generous to the Schedule 25 (Extra Large General Service) customers, since that class has grown by 120%, while the residential class has grown only 2%. Exhibit 168. The Company's proposal to assign above-average increases to the residential class is utterly unfair to residential customers.

133. Mr. Lazar has proposed that two classes, Small and Large General Service, get below-average increases, and the other classes get above-average increases. His proposal for a slightly above average increase to Residential reflects both the below-average growth, and the below-average parity ratio. The proposed below-average increase to Schedule 11 (Small General Service) reflects below-average growth and above-average parity ratio. A slightly below-average increase to Schedule 21 (Large General Service) reflects above-average parity ratio, little peak demand growth, and significant energy growth. Finally, a slightly above-average increase for Schedule 25 (Extra Large General Service) is probably generous on Mr. Lazar's part for a class with below-average parity ratio, and much faster than average growth.

134. Mr. Lazar's proposed rate spread fairly recognizes all of the guidance the Commission has historically provided – to consider relative class growth, economic conditions in the service area, and other factors, rather than mechanical application of the result of a cost of service study.

B. Electric Rate Design.

135. The main difference between the Company's proposed rate design and that offered by Mr. Lazar is that the Company puts the majority of the residential rate increase on the first 600 kWh per month of usage, while Mr. Lazar puts the increase on usage over 600 kwh per month, protecting small residential customers from this increase.

136. The Company/Staff proposal increases not only the price of electricity provided by expensive new resources, but actually increases the price of all usage by residential customers, including that provided by hydropower.

137. The record shows that the cost of hydropower remains very cheap, and that the first block of the residential rate (i.e., the first 600 kWh) is well above the cost of that hydropower. It is

equally clear that the last block of the residential rate is well below the cost of gas-fired generation on the Company's system. The record also shows that the first block usage includes the use of gas heat customers, who are facing massive increases due to soaring gas prices, while the third block reflects electric heat usage, and no matter what the Commission does in this case, electric heat customers will get smaller increases this winter than gas heat customers.

138. The Company proposal to shift this increase primarily to small residential customers should be rejected. The Company/Staff proposal puts 53% of the increase on the customer charge and the first block of usage. Exhibit 252, p. 6, l. 12 (Lazar Rebuttal).

139. The first block of residential usage can be met with hydro. The Company has 4.5 billion kWh of hydropower. Exhibit 203. This is enough to meet the first block of usage. Exhibit 252, p. 9, ll. 5-17 (Lazar Rebuttal). The current rate for the first block of usage is 43% above the cost of providing this service, even without applying a differential load factor to the three blocks. Exhibit 252, p. 10. The current rate for the third block of usage is 56% below the cost of providing this service, again without applying a differential load factor to the three blocks. *Id.* Mr. HIrschkorn testified on cross-examination that Avista did not take the differing costs of resources into account when designing the proposed rate blocks for residential customers in this case. Tr. 318:16-319:10.

140. Mr. Lazar's unrebutted testimony is that the third block has a lower load factor, and therefore a higher distribution cost, than the first block. Exhibit 241, p. 20 (Lazar Direct). The Company's witness, Mr. Hirschkorn, essentially confirmed Mr. Lazar's testimony that the first block is high load-factor lights and appliances, and the third block is low load-factor space conditioning. Tr.322:19-323:23.

141. The record is also clear that gas heat customers, who would be hurt by the Company proposal to raise the rate on the customer charge and first block, will be facing massive increases this winter. Their rates will be up 23% above last year and 60% above two years ago. Tr. 323:5-

19 (Hirschkorn). Gas rates will be up a massive 90% compared with 2002-03. Exhibit 252, p. 5, l. 21 (Lazar Rebuttal).

142. Short of denying Avista recovery of higher gas costs in its gas PGA, there is little the Commission can do to alleviate the plight of gas heat customers. Mr. Lazar has identified one tool that is available: keep the rate unchanged for the first 600 kwh of electricity usage unchanged, in recognition that the cost of meter reading, billing, and hydropower is not the cause of this rate increase.

143. The Lazar approach has many benefits:

a) It is relatively favorable for the gas, oil, and propane customers who are facing severe price impacts in the coming winter.

b) It moves the currently heavily subsidized third block of residential usage, over 1300 kWh per month, closer to cost.

c) It reflects the cost of gas resources in the end block, consistent with past Commission direction to keep hydropower benefits in the first block.

d) It avoids the situation where electric rates for electric heat are below gas rates for gas heat, which could cause customers to use plug-in heaters, driving up electricity usage and forcing more low-efficiency gas generation.

e) Finally, it is cost based with respect to the customer charge. Mr. Lazar's unrebutted testimony is that the current $5.00 per month customer charge exceeds the $4.87 in costs associated with meters, meter reading, and billing that the Commission has ruled are customer-related costs. Exhibit 252, p. 7. There is no basis whatsoever for increasing the customer charge.

C. Gas Rate Spread.

144. The Company's own gas cost of service study shows that residential service has a 100% parity ratio. Exhibit 241, p. 33 (Lazar Direct). The main difference between the Company gas cost of service study and that provided to Mr. Lazar for his testimony is the treatment of services,

the pipe that runs between the street and each customer's house. Mr. Lazar allocated the cost of services in the same manner as the costs are incurred – based on usage. The Company assigned these costs on a per-customer basis. The Company method is flawed. When this correction is incorporated in the Company study, it shows that the residential class is above parity.

145. Mr. Hirsckorn agreed that services are included in the line extension policy. He agreed that higher usage means greater Company contribution by the Company towards the cost of the service connections. Exhibit 164, Tr. 327:19-328:9. The Company method used in its gas cost of service study, assigning services on a per-customer basis, utterly ignores the basis on which these costs are incurred by the Company. If the customers are larger or will use more gas, the Company pays for the service pipe, and it is included in rate base. If the customer's usage is too small to justify this investment, the customer pays up front for the service pipe, and it does not get included in the Company's rate base.

146. With this correction, residential class is well above parity, and small commercial and large commercial are well below parity. Exhibit 241, p. 33 (Lazar Direct). Including gas costs, all classes are well within the range of reasonableness for a uniform increase, even using the Company cost study. Exhibit 248 (Lazar, JL-8). There is simply no basis for a differential rate increase by customer class. In light of this, it is not surprising that NWIGU signed onto the settlement proposal: the Company agreed to a decrease for this class.

The Company has mechanically followed the results of a flawed study. As stated above, the Commission ruled in the last fully contested Avista rate case that, on the issue of electric rate spread, "with a disputed cost of service study, however, we cannot take the Company's determination of 'unity' as an absolute goal," and noting that "[t]his Commission has never mechanically applied the results of a cost of service study, but exercises discretion in each determination." Docket UE-991606/UG-991607, ¶ 411. The order accepted a joint Staff/Public Counsel/ICNU recommendation of a uniform percentage increase, with a slightly smaller than average increase for the commercial class.

147. Here, Mr. Lazar has recommended a uniform percentage of margin increase. His recommendation should be adopted by the Commission.

D. Gas Rate Design.

148. This is a very small gas rate adjustment, regardless of whether the Commission adopts the Staff/Company proposal (about 1%), the Public Counsel proposal (slightly below 0%) or a figure in-between. All parties have agreed that, within each class, the rate adjustment should be applied as a small change to the rate per therm. This approach should be adopted by the Commission.

E. Direction for the Future on Rate Design and Rate Spread.

149. The Commission should use this docket to provide some guidance to the Company for the future. Evidence is that high gas costs and high energy costs generally are here to stay. Avista needs to consider this in any future rate filings. The Commission should direct the Company as follows:

1) The Company should be required to do an analysis of the load shape and load factor of residential customer usage by block. Mr. Lazar's unrebutted testimony is that load factor is higher in the first block, and lowest in the end block While this is intuitive – space conditioning usage is erratic and seasonal, some sophisticated analysis is in order. The Distribution component of rates should reflect these different load factors, with higher distribution charges applied to the upper blocks.
2) The residential rate blocks should also reflect resource costs, with the first block served by low-cost hydro resources, and the highest block served by the newer and more expensive gas-fired resources that are best suited to meeting erratic demands. The Commission originally ordered a "baseline" approach to residential rate design, recognizing that the first block represents "essential needs" and that electric heat usage is not an essential need, and is more elastic. U-78-05, Order, p. 22. The Company and staff witnesses testified they did not

consider this at all in reaching settlement. Tr. 322:19-323:23 (Hirschkorn); Tr. 172:10-14 (Steward).

3) The first block should reflect hydropower costs, and should reflect distribution costs appropriate to a high load factor, year-round usage for lights and appliances. The second block should reflect coal and other non-gas resources, and distribution costs appropriate for water heat and other usage typical of the middle block. Finally the third block should reflect natural gas generation and the distribution costs needed to serve the lower load-factor seasonal, irregular needs of electric heat consumption.
4) Fast-growing classes should get a bigger share of the cost of new resources than slower-growing classes. It is unfair for classes that are not growing, and therefore are avoiding the need for expensive new gas-fired resources, to have to pay for resources necessitated by the growth in other classes. The Commission should direct the Company to prepare an incremental cost study, assigning growth in resource costs in the "gas era" on the basis of class growth since the beginning of the gas era.
5) Rates for electric heat should be higher than rates for gas heat, or we risk encouraging customers to use plug-in heaters even if they have gas furnaces. Mr. Hirschkorn testified that gas furnaces are 80% efficient. Tr.325:17-18. Gas-fired generating resources significantly less efficient. The Company should make sure that there is not an incentive to fuel switch to electricity, as this increases gas usage (for generation) and puts even more pressure on the already-stressed gas market.

VII. LOW INCOME SETTLEMENT

A. The Low-Income Settlement Does Not Create New or Additional Sources of Funding.

150. Section 15(A) of the proposed settlement, Exhibit 2, describes so called "additional funding" that will be allocated to low-income assistance programs, but these funds do not actually represent new, additional sources of funding. Most of these so called "additional funds"

are rate payer funds, collected through the Schedule 91 and 191 tariff riders, that are only recently again "available" because the Company has retired a negative balance associated with the electric and natural gas DSM accounts due to the 2000-2001 energy crisis. Since 2002, Avista has only been spending about 62 cents on DSM programs, for every dollar collected from rate payers. Thus, about one-third of tariff rider revenues have been diverted away from programs to pay down the negative balance. Tr. 297:22 – 298:8. Avista witness Mr. Hirschkorn confirmed at the hearing that the $200,000 in "additional funding" for low-income DSM is now available because the negative tariff rider balance has been recovered. Tr. 299:14-19. *See also* Exhibit 166. Mr. Hirschkorn also stated that $600,000 in "additional funding" ($300,000 per year for two years) for the Low-Income Rate Assistance Program (LIRAP) are actually unspent funds that are already collected from rate payers as part of the Schedule 191 natural gas DSM tariff rider. Tr. 306:7-15. So while the proposed settlement characterizes these funds as "additional funds," in fact they are funds that are already collected from rate payers – they will simply be shifted to low-income programs now that they are not needed to recover the negative balance.

151. As part of the proposed settlement, Avista would also contribute their 2005 public utility tax credit, which they anticipate will be $600,000, to LIRAP -- $300,000 per year for two years. Tr. 304:19 – 305:12. While laudable, this has in fact been Company practice in recent years, and thus the proposed settlement does not really create a new commitment for Avista. Avista witness Mr. Hirschkorn stated that "over the past several years the Company has provided approximately 90% of the tax credit dollars to either low income DSM or LIRAP funding." Tr. 304:2-5. He also indicated that if the Company receives a tax credit for 2006, it would provide those funds to LIRAP or low-income DSM, although the settlement does not require this. Tr. 305:2–306:5.

B. The Low-Income Provisions Do Not Create a Justification For Approval of The Rate Increases in the Settlement.

152. Public Counsel does not oppose the reallocation of funds to low income DSM and LIRAP programs, but we do not view these provisions as creating any independent reason to support or approve the settlement. Energy Project witness Mr. Eberdt estimated that approximately 30% of eligible low-income customers are currently served by LIRAP or the Low-Income Home Energy Assistance Program (LIHEAP), a federal program. Tr. 162:3-6. The 70 percent of customers who are eligible, but won't be served by these programs, would fare best if the Commission ensures that Avista's rate increase is not at an excessive level.

Public Counsel opposes the provision of the proposed settlement that would prohibit any increase in the Schedule 191 natural gas DSM tariff rider before January 1, 2008. In an environment of rising natural gas prices, placing a cap on energy efficiency funding makes absolutely no sense. As Avista's Mr. Hirschkorn recognized, the demand for energy efficiency programs is growing:

> ...my understanding is we're in an IRP process right now in Washington as well as Oregon, and with increase in gas rates, price of gas we're seeing as well as increase in electricity costs, that would make more measures become cost effective over time, so I think the need is going to grow. Tr. 307:9-14.

Adoption of this provision would tie the Company's hands in responding to that growing need.

VIII. PUBLIC COMMENT

A. The Spokane Public Hearing.

153. A public hearing was held in Spokane on October 11, 2005. The hearing was well-attended, with 25 witnesses addressing the Commission and some submitting written comments. None of the witnesses who spoke supported the rate increases proposed in the settlement. Several witnesses did support the low-income provisions. Witnesses included senior citizens, elected officials, community action agency staff, representatives from the area agency on aging, a labor

union official, and large business representatives. Speakers came from a number of locations outside Spokane, including Stevens County, Whitman County, and Colfax.

154. Flo Tillman of Spokane testified:

> And then this increase is not just gonna stop at our houses, its going to be increased for the commercial and all of the people downtown that we do business with. So they're not gonna eat this, they're gonna pass it on to us. So we're gonna be paying for their utility bills as well. It's not gonna stop there....There's just too many people in this entire country, not just Spokane or Spokane Valley or the State of Washington, that are in hurtsville. Tr. 43:23-44:3, Tr. 44:10-12.

155. Gary Douglas, Vice President of United States Steelworkers Local 167, representing workers at Inland Empire Paper Co. testified:

> I'm asking you tonight to review this case. The Commission should seriously review all of Avista's finances. We the people are not to be made accountable for Avista's downfalls. I have concerns that if this $24,000,000 is granted, it will affect my job and the jobs of 90 other employees and their families, not to mention the other industries and people of this community. Tr. 46:17-23.

156. Wayne Andresen, President and General Manager of Inland Empire Paper also testified in opposition to the rate increase, noting that electricity accounts for 18 % of their manufacturing costs and calculating that increases since 2001 have cost the Company over $7 million. Tr. 53:4-8. Representatives from Boise Cascade, Tr. 47:18, and Simplot facilities, Tr. 54:22, in Avista's service area also spoke against the increase.

157. Henry Stein, a landlord, spoke of the problems faced by renters who would experience the pass-through of the increase. Tr. 68:1-2. Troy Dilley, a renter, testified that in his apartment building, "a lot of people are using fireplaces because they are trying to cut hearing costs, which is baseboard hearing, which draws the most electricity." Tr. 69:4-7. Nick Beamer, from the Advocacy Partnership for Long-Term Care, supported the Public Counsel recommendations, as well as the low-income settlement. Tr. 60:22-61:18.

158. John O'Rourke, on behalf of the Citizens Utility Alliance of Washington, endorsed the low-income settlement, but also testified:

> However, I think you understand that even with the increase in this funding, for instance there will only be enough funding to help, I think it's just less than 1/3 of the people eligible for heating assistance in Spokane. And given the increase in this case, the proposed increase, the coming giant increases in natural gas, I think its not alarmist to say that the State of Washington faces a rate increase shock in energy. Tr. 70:22-71:5.

B. Written Public Comment.

159. Public testimony Exhibit 6 consists of letters, e-mails, and other written materials submitted by the public to provide comment on this case. The letters and other materials were submitted to the Commission and the office of Public Counsel. The exhibit includes a total of 378 written comments. Of these 360 oppose the rate increase, with the remaining not stating support or opposition.

160. Jackie Silvey of Spokane wrote:

> Gentlemen:
>
> I am writing to protest the rate increases proposed by Avista upon the people who have no recourse to pay them. I am a senior citizen struggling to live on a monthly income of $996.00 a month. I and other like me, single parents, low income families are so often neglected when it comes to big business. Let Avista stop paying its executive large bonuses, share gifts etc and put the money back into their expansion programs. I cannot afford anymore increases. My comfort level [billing program] 2 years a go [sic] was $68.00 a month it now is over $95.00 a month and is expected to go higher. This monies is being taken out of my food budget. I really feel my voice is going into a giant void and no one pays any attention to me or others like me. Again, I vehemently oppose a rate increase under docket # UE050482 and UG050483.
>
> Exhibit 6, p. 12 (letter received at WUTC April 26, 2005).

161. Janet Angulo wrote:

> Dear Sirs:
>
> I am writing to regarding Avista Utilities current request for yet another rate increase for both electricity and natural gas. When will they be satisfied? We read of huge bonuses for top executives (more than my entire income for 10 years) and a proposed 10.4 % return to investors. Their generosity is marvelous, but it comes from the pockets of people who haven't go enough to live on comfortably themselves.

I am on a disability pension and my gross income is less than $600 a month. I currently pay Avista Utilities $236 a month for heat and electricity. It is a "Comfort Level" (!!) billing, so I pay that much every month, year round. It is also 39.5% of my gross income and more than I pay for all other utilities plus property tax and homeowners insurance put together. Another increase or two from Avista and I will no longer be able to afford to live in a home that I own.

Please stop the constant rate increases from Avista Utilities. They are causing increasing hardship among the elderly and disabled, two groups of people who need help and consideration and are least able to make themselves heard by large companies and multiple layers of well-paid executives.

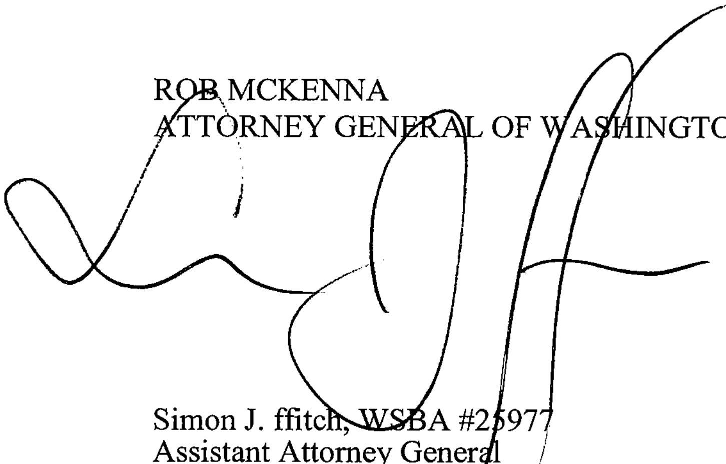
Exhibit 6, p. 10 (letter received at WUTC, October 18, 2005).

IX. CONCLUSION

162. For the foregoing reasons, Public Counsel recommends that the Commission reject the proposed settlement. It is does not establish rates that are just and reasonable. The rate levels, rate spread, rate design and the modifications to the Energy Recovery Mechanism are not in the public interest.

DATED this 14th day of November, 2005.

ROB MCKENNA
ATTORNEY GENERAL OF WASHINGTON



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