BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

POST-HEARING BRIEF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

November 14, 2005

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1 The Industrial Customers of Northwest Utilities ("ICNU") submits this Post-Hearing Brief in Washington Utilities and Transportation Commission ("WUTC" or the Commission") Docket Nos. UE-050482 and UG-050483, requesting that the Commission reject the Settlement Stipulation ("Stipulation") entered into between Avista Corporation ("Avista" or the "Company"), Staff, and certain intervenors in this proceeding (collectively, the "Settling Parties").

I. SUMMARY OF ARGUMENT

2 The Stipulation does not represent a fair and just resolution of Avista's request for a general rate increase, and it will harm customers by establishing rates that exceed those that are justified by the evidence in the record. ICNU and Public Counsel, the primary representatives of Avista's electric customers, both oppose the Stipulation and have demonstrated that adopting the Stipulation is unjustified. The evidence provided by ICNU and Public Counsel establishes that:

- Staff entered into the Stipulation without completing a comprehensive review of the case and before Avista had answered Staff data requests on critical issues, particularly issues related to power costs. In addition, Staff has not provided any evidence or analysis to dispute any of the adjustments proposed by ICNU and Public Counsel. As a result, Staff's support for the Stipulation is entitled to little or no deference.

- There is no record upon which the Commission can conclude that the 10.4% return on equity ("ROE") proposed in the Stipulation is reasonable. In fact, the evidence shows that a 10.4% ROE is too high, and that a ROE of 9.8% is appropriate.

- Avista's actual level of equity invested in utility operations is 27%. As a result, the hypothetical 40% equity ratio proposed in the Stipulation will result in an actual ROE of 12.9%, which is unsupported by the evidence. In addition, the proposed equity building mechanism does not provide meaningful assurance that the Company would use increased revenues to pay down debt.

- Adopting the ROE and capital structure proposed in the Stipulation will increase Avista's revenue requirement by $12.4 million compared to using a 9.8% ROE on Avista's actual utility equity of 27%.

- Avista acquired the second half of Coyote Springs 2 ("CS2") in late 2004, substantially increasing the Company's exposure to the risk of gas price variations. Avista's failure to develop or implement a reasonable gas supply strategy for Coyote Springs was imprudent.

- Avista also failed to develop or implement an adequate risk management program, which resulted in Avista having a significant unhedged gas position for the rate year. The lack of a risk management program combined with Avista's unhedged gas position unnecessarily exposes customers to an excessive amount of risk.

- The Stipulation would reduce the Energy Recovery Mechanism ("ERM") deadband by $6 million at a time when the Company is increasing its exposure to changes in gas prices. Reducing the deadband will result in an unwarranted shift of risk from Avista to customers that violates the agreement under which the ERM was created.

- Avista's Aurora power cost study overstates power costs by using a number of selective, result-oriented choices for modeling inputs, which should be replaced with more realistic values.

3 ICNU recommends the following necessary adjustments to Avista's power costs:

Issue	**Washington Jurisdiction Adjustment**
Hydro Modeling	-$5,438,000
Hydro Shaping	-$2,776,000
Colstrip Capacity	-$1,432,000
Colstrip Planned Outages	-$1,643,000
Colstrip Forced Outage	-$795,000
Generic Plant Maintenance	-$358,000
Bidding Factors	-$1,575,000
Total	-$14,017,000

4 Further, Public Counsel proposes additional non-duplicative adjustments. Thus, the evidence demonstrates that Avista is entitled to no increase in its revenue requirement in this proceeding. ICNU's adjustments related to ROE, equity ratio, and power costs exceed the

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revenue requirement increase proposed by the Stipulation. Therefore, the Commission should reject the Stipulation because it would increase rates by an amount that far exceeds just and reasonable levels. In the event the Commission approves the Stipulation, it should condition its approval on agreement by the Settling Parties to reduce the Stipulation revenue requirement increase by the amount of each of the ICNU adjustments as well as non-duplicative Public Counsel adjustments. Further, any rate increase approved in this proceeding should be entirely allocated to reducing Avista's ERM deferral balance.

II. BACKGROUND

5 The rate increase requested by Avista in this proceeding follows a series of dramatic rate increases that the Company has implemented since 2000. These recent rate increases have been primarily driven by poor decisions related to power generation and the financial effects of mistakes made by Avista's management in both regulated and unregulated operations. As a result, Avista has been unable to deliver cost effective electricity, despite having an abundance of low cost hydro generation.

6 These rate increases have had a devastating impact on Avista's largest customers. Boise Cascade, one of Avista's industrial customers on Schedule 25, submitted comments stating that the purchase of electricity represents the second most significant cost at its Kettle Falls sawmill, that its costs of electricity had increased 60% between 2002 and 2004, and that, in September 2005, Boise eliminated a shift at its Kettle Falls sawmill due to poor economic conditions.[1/]

[1/] Exh. No. 6 (Letter from Thomas A. Insko, Region Manager, Boise Wood Products, to Mark Sidran, Chairman, WUTC at 1 (Oct. 10, 2005)).

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7 Similarly, Inland Empire Paper Company ("IEP"), Avista's largest Washington electric customer, submitted a letter stating that electricity is its largest manufacturing expense and that it was difficult for IEP to compete with other newsprint mills because it has the fifth highest electric rates out of thirty-nine other competing mills responding to a 2004 survey.[2/]

8 The Commission should recognize that the dramatic rate increases approved for Avista since 2000 were the result of imprudent actions by Avista's former management.[3/] Avista also made poor decisions with respect to the energy crisis regarding its risk management policies. Nevertheless, these rate increases have greatly improved Avista's financial condition, particularly on the regulated side.[4/] As such, customers should no longer bear the cost of a hypothetical capital structure and an unnecessarily high rate surcharge designed to address Avista's financial predicament in 2000-01.

9 Finally, the Commission should acknowledge that customers should not be subject to the risks of Avista's unregulated businesses. These businesses have suffered, and continue to suffer, significant losses.[5/] The Commission should strive to fully protect customers from unregulated activities that have been a significant strain on Avista Corporation, while the utility's earnings have remained steady or improved.

2/ Letter from Wayne Andresen, President and General Manager, IEP, to WUTC at 1 (Oct. 21, 2005). IEP's letter stated that the survey showed that IEP's Canadian competitors paid and average of $31.95/MWh, that the U.S. average was $33.95/MWh, and that IEP was charged $41.71/MWh by Avista. Id.

3/ Re Avista, WUTC Docket No. UE-010395, Sixth Supp. Order 91 at ¶ 32-34 (Sept. 24, 2001).

4/ Exh. No. 35; TR. 419:23, 421:13-19 (Avera).

5/ Exh. No. 67 at 4.

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III. CAPITAL STRUCTURE AND COST OF CAPITAL

10 The Settling Parties have agreed to an overall rate of return of 9.11%, based on a 10.4% ROE ("ROE") and a 40% common equity component.[6] A 10.4% ROE is excessive in the current low-cost capital market environment.[7] In addition, the Commission should not approve a common equity ratio of 40% when Avista Utility's actual common equity ratio currently is 27%.[8] Although the Company has argued that "supportive decisions" in these areas are necessary for Avista to move towards an investment-grade credit rating,[9] the fact is that Avista's credit ratings have been hurt by the poor performance of the Company's non-regulated subsidiaries, not by the utility's performance.[10] Moreover, while the Company claims that Avista is a "risky" utility, Avista's 10-Q, dated August 5, 2005, states that Avista's net income increased from $19.9 million in 2004 to $37.4 million in the six months ending June 2005.[11] Thus, the evidence in the record shows that Avista's financial performance is improving, even with below-average water conditions in 2005.

11 The Settling Parties argue that unless the Commission approves the Stipulation, the Company may not be able to improve its credit rating, but they present no evidence to substantiate this claim.[12] Similarly, in his rebuttal testimony in this proceeding, Dr. William Avera, Avista's witness on ROE and capital structure, has repeatedly cited the recent decisions of Standard & Poor's and Fitch to downgrade Central Vermont Public Service Corporation's

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[6] Exh. No. 2 at 2-3.
[7] Exh. No. 331 at 4:3-6 (Gorman Direct).
[8] Exh. No. 1 at 11:7-9 (Settling Parties).
[9] Exh. No. 31 at 18:23-28 (Malquist Direct).
[10] Exh. No. 33 at 2, 8-9.
[11] TR. 419:23, 421:13-19 (Avera); Exh. No. 35.
[12] Exh. No. 1 at 9:1-8 (Settling Parties).

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credit rating to below investment grade as evidence that an "unfavorable rate order" can hurt a utility's credit rating.[13]

12 Dr. Avera fails to point out that the event that precipitated the downgrade was a Vermont Public Service Board order finding that Central Vermont had been overcharging its customers and ordering Central Vermont to pay $6 million in refunds and reduce its rates by 1.88%.[14] It should hardly come as a surprise that the ratings agencies would downgrade a utility's credit rating in light of such an order. The experience of Central Vermont does not, as Dr. Avera suggests, illustrate that a utility is at risk of a credit rating downgrade any time a regulatory agency adopts a lower ROE or common equity ratio than the utility requests.[15]

A. Return on Equity

1. Summary of ICNU's Position on Return on Equity

13 The general framework for determining a regulated utility's cost of common equity is framed by two U.S. Supreme Court decisions, Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia, 262 U.S. 679 (1923), and Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). These decisions establish that a public utility's authorized return should: 1) be sufficient to maintain financial integrity; 2) attract capital under reasonable terms; and 3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk.[16]

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[13] Exh. No. 62 at 5:11-15, 58:18 – 59:15 (Avera Rebuttal).

[14] Re Central Vermont Pub. Serv. Corp., Vermont Pub. Serv. Bd. Docket Nos. 6946 and 6988, 2005 Vt. PUC LEXIS 65; 241 P.U.R. 4th 1 (Mar. 29, 2005).

[15] Exh. No. 62 at 5:11-15; 58:18 – 59:15 (Avera Rebuttal).

[16] WUTC v. Avista Corp., WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at 89 (Sept. 29, 2000).

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14 ICNU's witness, Michael Gorman, combined three methods to determine his recommended ROE for Avista: 1) the constant growth discounted cash flow ("DCF") model (8.8%); 2) the bond yield plus equity risk premium model (9.8%); and 3) a capital asset pricing model ("CAPM") (10.9%).[17/] Mr. Gorman applied these models to a proxy group of publicly traded utilities that were reasonably comparable to Avista in terms of investment risk.[18/]

15 These analyses produced an estimated ROE range for Avista of 9.0% to 10.3%.[19/] Based on this result, Mr. Gorman recommended 9.8% as an appropriate ROE for Avista.[20/] Mr. Gorman explained that it is important to adopt an overall ROE based on the midpoint of the three models, because doing so "will balance the competing interests of investors and customers."[21/]

a. DCF Model Results

16 The DCF model "attempts to measure what level of equity return investors will demand in the market for a particular company, thus measuring that company's cost of money in the equity market."[22/] The model has three components: a current stock price, an expected dividend, and an expected growth rate in dividends.[23/] For current stock prices and expected dividends, Mr. Gorman used the average of the weekly high and low stock prices over a 13-week period and the most recently paid quarterly dividend, respectively.[24/]

17/ Exh. No. 331 at 24 (Gorman Direct).
18/ Id. at 11:19-21.
19/ Id. at 24:8-9.
20/ Id.
21/ Id. at 24:18-20.
22/ WUTC v. PSE, Docket Nos. UG-040640, UE-040641, UE-031471 and UE-032043 ("UG-040640 et al."), Order No. 06 at ¶ 42 (Feb. 18, 2005).
23/ Exh. No. 331 at 13:18-19 (Gorman Direct).
24/ Id. at 13:22 – 14:10.

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17 To estimate dividend growth rates, "one must attempt to estimate what the consensus of investors believes the dividend or earnings growth will be."[25/] To do this, Mr. Gorman used the average of three published sources of customer growth rate estimates that were available on August 19, 2005.[26/] The consensus analysts' growth rate for the proxy utility group was 4.57%, which was "reasonably consistent with the consensus of economists' five and ten-year projected GDP growth rate of 5.3%."[27/] From this, Mr. Gorman concluded that the resulting growth rates were "conservatively high," because "[g]rowth rates that approximate the long-term projected GDP growth rate represent the maximum sustainable growth rate for electric utility companies."[28/] Another indication that Mr. Gorman's growth rate was conservative compared to the GDP growth rate was that "the growth rate in utility dividends historically has been dramatically lower than the nominal GDP growth rate."[29/]

18 Mr. Gorman's DCF analysis resulted in a cost of common equity estimate for the proxy utility group of 8.8%.[30/]

b. Risk Premium Model Results

19 Mr. Gorman's risk premium model used two estimates of the difference between the required return on common equity and the yield on a bond. Based on authorized returns for electric utility companies, Mr. Gorman estimated the risk premium on an annual basis for each

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25/ Id. at 14:15-16.
26/ Id. at 15:1-14; Exh. No. 335.
27/ Exh. No. 331 at 16:3-4 (Gorman Direct).
28/ Id. at 16:21, 16:4-6.
29/ Id. at 17:2-3; Exh. No. 337.
30/ Exh. No. 331 at 15:17-18 (Gorman Direct); Exh. No. 336.

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year over the 1986-2004 time period.[31] Mr. Gorman selected this time period because public utility equities consistently traded at a premium to book value during these years.[32]

20 The first estimate took the difference between the required return on utility equity and Treasury bond yields to estimate an average equity risk premium of 4.96%.[33] To estimate Avista's cost of common equity, Mr. Gorman added the estimated equity risk premium to a projected long-term Treasury bond yield of 5.2%, based on Blue Chip Financial Forecasts.[34] This produced an estimated common equity return in the range of 9.6% to 10.9%, with a midpoint of 10.3%.

21 The second estimate took the difference between commission authorized returns on equity and contemporary A-rated utility bond yields to estimate an average equity risk premium of 3.54%.[35] Mr. Gorman then added the equity risk premium to the current 13-week average yield on "Baa" rated utility bonds for the period ending July 1, 2005.[36] This resulted in a cost of equity in the range of 8.8% to 9.8%, with a midpoint of 9.3%.[37]

22 Combining the two estimates, the result of the risk premium analysis was a common equity return estimate in the range of 9.3% to 10.3%, with 9.8% as the midpoint.[38]

23 Dr. Avera criticizes Mr. Gorman's risk premium analysis because, "Mr. Gorman failed to incorporate the inverse relationship between interest rates and equity risk premiums in

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[31] Exh. No. 331 at 18:11-14 (Gorman Direct).
[32] Id. at 18:18-19; Exh. No. 338.
[33] Exh. No. 331 at 19:3-11 (Gorman Direct); Exh. No. 339.
[34] Exh. No. 331 at 19:21-24 (Gorman Direct).
[35] Exh. No. 331 at 19:12-18 (Gorman Direct); Exh. No. 340.
[36] Id. at 19:24-20:1-7; Exh. No. 341.
[37] Exh. No. 331 at 20:7-10 (Gorman Direct).
[38] Id. at 20:11-12.

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his analysis of historical authorized rates of return."[39] Dr. Avera, however, fails to provide credible support for his theory regarding this "inverse relationship." In fact, in one of the studies Dr. Avera cites to support his theory, the authors themselves came to the conclusion that they "were unable to find a significant relationship between risk premiums and interest rates."[40] Moreover, at least three regulatory commissions have rejected Dr. Avera's argument that an inverse relationship exists between interest rates and equity risk premiums.[41] In short, Dr. Avera has failed to prove that such an inverse relationship currently exists, and the Commission should reject his argument.

c. Capital Asset Pricing Model Results

24 Mr. Gorman also performed a CAPM analysis, which contains three elements: the company's beta, the risk-free rate, and the market risk premium.[42] A company's beta represents the measure of risk in a single stock as compared to the risk in the broader market.[43] In his analysis, Mr. Gorman used the estimate of the group average beta for his proxy utility group, based on the Value Line Investment Survey, as the beta.[44] Mr. Gorman explained that he relied on group average beta because it is more reliable than a single company beta and therefore produces a more reliable return estimate. The resulting group average beta was 0.86.[45]

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[39] Exh. No. 62 at 65:15-17 (Avera Rebuttal).

[40] Re Conn. Power & Light Co. Conn. Dept. of Pub. Util. Control Docket No. 97-05-12, 1997 Conn. PUC Lexis 8 at *173 (Dec. 31, 1997) (quoting Willard T. Carleton, Donald R. Chambers, and Josef Lakonishok, Journal of Finance 430 (May 1983)).

[41] Id. at 172-174; Re Pub. Serv. Co. of Colo., Colo. Pub. Utils. Comm'n Docket No. 93S-001EG, 148 P.U.R. 4th 1 (Oct. 14, 1993); Re N.C. Power, N.C. Utils. Comm'n Docket No. E-22, 142 P.U.R 4th 117 (Feb. 26, 1993).

[42] Exh. No. 331 at 21:15-16 (Gorman Direct).

[43] WUTC Docket Nos. UG-040640 et al., Order No. 06 at ¶ 52.

[44] Exh. No. 331 at 22:14, 22:19-20 (Gorman Direct).

[45] Id. at 22:14-21; Exh. No. 342.

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25 To estimate the risk-free rate, Mr. Gorman used the Blue Chip Financial Forecast's projected 20-year Treasury bond yield of 5.2%.[46/] Mr. Gorman used long-term Treasury bonds because they are considered to have negligible credit risk, and they have an investment horizon similar to that of common stock.[47/] Because a Treasury bond yield is not a risk-free rate, however, Mr. Gorman noted that using a Treasury bond yield as a proxy for the risk-free rate of return in the CAPM analysis for companies with betas less than one can produce an overstated estimate of the CAPM return.[48/]

26 Mr. Gorman's CAPM analysis used two estimates of the market risk premium, one that was forward-looking and one based on a long-term historical average.[49/] The forward-looking estimate was 6.7%, and the historical estimate was 6.6%.[50/] Putting these elements together, Mr. Gorman's resulting CAPM estimate was 10.9%.[51/]

d. ICNU's Conclusion on Return on Equity

27 Based on the results of his Constant Growth DCF, Risk Premium, and CAPM analyses, Mr. Gorman recommended that the Commission adopt an overall ROE at the midpoint of the three models: 9.8%.[52/] He recommended that the Commission not establish Avista's ROE based on the results of only one of the models, because "arbitrarily selecting one model's results or another's will tilt the regulatory balance in favor of investors at the expense of customers or vice versa."[53/] Mr. Gorman also pointed out that it would be "particularly inappropriate to set a

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[46/] Exh. No. 331 at 21:19-20 (Gorman Direct).
[47/] Id. at 21:23 – 22:1.
[48/] Id. at 22:7-12.
[49/] Id. at 22:23-24.
[50/] Id. at 23:1-20.
[51/] Id. at 23:22; Exh. No. 343.
[52/] Exh. No. 331 at 24:8-9 (Gorman Direct).
[53/] Id. at 24:16 – 25:2.

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utility's ROE on only the CAPM analysis."[54] The CAPM is calculated using five years of historical data to establish the estimated utility data. Utility risk during the past five years "was plagued by extremely volatile and uncertain wholesale markets, bankruptcies, and accounting irregularities," but currently the utility industry is moving back towards concentration on low-risk regulated utility operations. As a result, the CAPM returns that are based on recent historical data are not appropriate for developing a stand-alone ROE estimate.[55]

2. Argument in Support of ICNU's Recommendation

a. The Company Has Failed to Meet Its Burden of Proving That a 10.4% Return on Equity Is Appropriate

28 The Commission should reject the Stipulation because there is no record upon which to conclude that the 10.4% ROE in the Stipulation is the proper ROE for Avista. In the alternative, if the Commission approves the Stipulation, it should condition its approval on the Settling Parties agreeing to a lower ROE.

29 The burden of proving that a proposed rate increase is just and reasonable remains at all times on the Company.[56] Despite the Stipulation, when the Commission reviews the evidence in this proceeding, the ultimate burden of proof remains by statute on the Company.[57] In this case, the Company has failed to present evidence to support even a *prima facie* case for a 10.4% ROE.

30 The joint testimony in support of the Stipulation is sponsored by Kelly Norwood, Brian Hirschkorn, Roger Braden, Mike Parvinen, Hank McIntosh, Joelle Steward, Don

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[54] Id. at 25:4-5.
[55] Id. at 25:8-17.
[56] RCW 80.04.130; Re Avista, WUTC Docket No. UG-041515, Order No. 06 at ¶¶ 22-23 (Dec. 7, 2004).
[57] WUTC Docket No. UG-041515, Order No. 06 at ¶ 24.

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Schoenbeck, and Charles Eberdt, none of whom are experts on ROE issues. Avista's cost of capital expert, Dr. Avera, is not a sponsoring witness of the joint testimony.[58/]

31 To support the reasonableness of the 10.4% ROE, the joint parties state that "the average equity return authorization by state commissions nationwide for the first six months of 2005 was 10.36% for electric utilities … and 10.56% for natural gas utilities."[59/] In addition, they report that a 10.4% ROE is comparable to the 10.3% and 10.0% returns on equity granted to Puget Sound Energy ("PSE") and PacifiCorp, respectively, in recent Washington and Oregon rate cases.[60/]

32 This is not sufficient evidence upon which to set a utility's ROE. As this Commission has explained:

> While the determination of the cost of common-equity capital requires the exercise of judgment, the use of judgment must be informed by the facts. If meeting the burden of proof through opinion testimony has any meaning, it means that the witness must present a logical connection between the factual evidence presented and the opinion offered.[61/]

Thus, while it is true that there is no "precise science" to establishing the proper ROE, it must be "an exercise in informed judgment" in consideration of "the competing financial analysis evidence."[62/]

33 The Settling Parties have failed to present financial analysis evidence for the Commission to consider in support of a 10.4% ROE. While information about equity returns

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58/ At the hearing, counsel for ICNU repeatedly asked Dr. Avera whether he was the sponsoring witness for the ROE that is agreed to in the settlement. Dr. Avera refused to say that he was the sponsoring witness. TR. 402:8 – 405:22 (Avera).

59/ Exh. No. 1 at 14:13-16 (Settling Parties).

60/ Id. at 14:3-10.

61/ WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 355.

62/ WUTC Docket Nos. UG-040640 et al., Order No. 06 at ¶ 80.

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awarded to other utilities or in other jurisdictions may be useful as a "check" against which the Commission can compare its conclusion, it is not financial analysis evidence that directly supports a 10.4% ROE.[63/] Moreover, in this case, Avista's reliance on the recent authorized returns for PSE, PacifiCorp, and other utilities across the country is misplaced, because those authorized returns were typically based on the actual or reasonable projections of the test year common equity balance for those utilities. In contrast, the 10.4% ROE in the Stipulation is based on an equity balance that, as described in greater detail below, is highly inflated.[64/]

34 Notably, Avista's expert witness on rate of return issues, Dr. Avera, did not sponsor testimony in support of the settlement on ROE.[65/] At hearing, however, Dr. Avera testified that both his direct and rebuttal testimony support a 10.4% ROE.[66/] This is puzzling in light of the fact that Dr. Avera concluded in his direct testimony that "the 11.5% ROE requested by Avista falls at the low end of a reasonable range applicable to Avista's 2006 rate year."[67/] Dr. Avera's reasoning appears to be that because his testimony supports an 11.5% ROE, it also supports a lower ROE, so long as it is not as low as that proposed by ICNU or Public Counsel.[68/] Dr. Avera's credibility also is questionable because he maintained in his testimony that an ROE below 11.5% would have significant impact on Avista's ability to attract capital.[69/]

35 Dr. Avera's logic is flawed. The Commission cannot establish 10.4% ROE for Avista without analysis that includes financial evidence of how the 10.4% number was

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63/ Id.
64/ Exh. No. 344 at 2:17-21 (Gorman Rebuttal).
65/ TR. 405:4-22 (Avera).
66/ TR. 408:6-8 (Avera).
67/ Exh. No. 50 at 5:4-5 (Avera Direct).
68/ TR. 414:6 – 415:8 (Avera).
69/ Exh. No. 50 at 6:27 – 6:7 (Avera Direct); TR. 407:6-12 (Avera).

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determined.[70/] The evidence in the record is that the Settling Parties arrived at the 10.4% number through "a give and take over a period of days when different parties made different offers."[71/] This evidence is insufficient to meet the burden to demonstrate that 10.4% is a reasonable ROE.

b. A Reduced Deadband Should Correspond with a Reduced Return on Equity

36 The Settling Parties have agreed to reduce the deadband in Avista's ERM from $9 million to $3 million.[72/] ICNU strongly opposes reducing the deadband, but if the Commission accepts this proposal, it also should reduce rates via a lower ROE.[73/] Reducing the deadband will shift a larger portion of the risk associated with fuel and purchased power cost recovery to customers.[74/] A lower ROE is appropriate to compensate for Avista's reduced risk.[75/]

c. Setting the Common Equity Ratio at 40% Will Increase Avista's Actual Return on Equity

37 As explained below, ICNU disagrees that Avista's common equity ratio should be set at 40% when Avista's actual end-of-year 2004 common equity ratio for utility operations is 27%. If the Commission accepts the 40% equity ratio proposed in the Stipulation, it will effectively allow Avista to earn a 12.9% ROE on the actual 27% common equity ratio that is invested in utility operations.[76/] Dr. Avera conceded this fact at the hearing.[77/] Such an inflated common equity return opportunity is significantly higher than other recently authorized common

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70/ See WUTC Docket No. UG-040640 et al., Order No. 06 at ¶ 80.
71/ TR. 407:18-20 (Avera).
72/ Exh. No. 1 at 25:12-13 (Settling Parties).
73/ Exh. No. 331 at 8:5-10 (Gorman Direct).
74/ Id. at 8:4-5.
75/ Id. at 8:5-8.
76/ Exh. No. 344 at 2:22 – 3:2 (Gorman Rebuttal).
77/ TR. 417:16-418:1 (Avera).

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equity returns.[78] Imputing a 40% common equity ratio with at 10.4% ROE increases the gas and electric combined revenue requirement by \$9.986 million, while using the actual common equity ratio of 27% with a 9.8% ROE increases it by \$12.401 million.[79]

B. Capital Structure

1. Avista's Consolidated Capital Structure Should Not Be Imputed to the Regulated Utility

38 The Commission has explained that it determines a utility's appropriate capital structure on a case-by-case basis:

> Establishing a capital structure for ratemaking purposes requires the Commission to strike an appropriate balance between debt and equity on the bases of economy and safety. The economy of lower cost debt, on which the Company has a legal obligation to pay interest, must be balanced against the safety of higher cost common equity on which the Company has no legal obligation to pay a return at any particular time. The Commission has used actual, pro forma, or imputed capital structures to strike the right balance and determine overall rate of return on a case-by-case basis.[80]

39 In this case, it would be inappropriate to impute the capital structure of the consolidated company to the utility, because doing so would place the burden of building up Avista Utility's equity capital on ratepayers, when it should be the obligation and burden of Avista's common shareholders.[81] Especially at a time when the Company does not appear to be attempting to maximize its retained earnings, the Commission should not allow a higher common

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78/ Exh. No. 344 at 3:2-6 (Gorman Rebuttal).
79/ Id. at 4:16-24; Exh. Nos. 346 and 347.
80/ WUTC Docket Nos. UG-040640 et al., Order No. 06 at ¶ 27 (internal footnotes omitted).
81/ Exh. No. 331 at 9:2-6 (Gorman Direct).

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equity ratio to increase Avista's ability to pay down debt. Avista has increased its dividend payments to investors three times in the last 18 months.[82/]

40 At the hearing, Dr. Avera testified that Avista's customers are currently benefiting from the Company's $257 million investment in equity in Avista's unregulated businesses that have a year-to-date loss of 17 cents per share.[83/] Dr. Avera believes this is true despite the fact that Avista Energy's substantial losses create a risk, because that is simply "[t]he nature of the energy business versus the utility business."[84/] Dr. Avera explained: "[t]he energy business has more variability. It has downside losses and it has upside gains. The utility business is more stable. When you combine them together in a portfolio, you have a more stable portfolio."[85/] In other words, Dr. Avera believes that Avista's ratepayers benefit because the stability of the utility business contributes to the stability of Avista Corporation's portfolio.

41 As Mr. Gorman explained, Dr. Avera's position is untenable:

> [I]n direct response to Dr. Avera that these non-regulated companies are benefiting regulated operations, that completely contradicts the clear evidence that the subordinate debt of the utility costs significantly more than the [first] mortgage debt of the utility, far more than one would reasonably expect if you look at the utility without the non-regulated investment risk that this company has, the differential. So there is no real benefit in the debt cost calculations, and I strongly disagree with him that there's any benefit at all to the equity investments in non-regulated companies in terms of ensuring the utility's ability to attract capital.[86/]

In this case, it has been shown that setting Avista's rates on the basis of the proposed hypothetical capital structure will result in a nearly $10 million increase in Avista's electric and

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[82/] Id. at 2:13-14.
[83/] TR. 424: 10-17 (Avera).
[84/] TR. 427:19-20 (Avera).
[85/] TR. 427:20-24 (Avera).
[86/] TR. 464:17 – 465:4 (Gorman).

gas combined revenue requirement.[87/] In PSE's recent rate case, Staff argued against setting rates on the basis of a hypothetical equity ratio instead of the actual expected equity ratio over the course of the rate year, because using the hypothetical equity ratio "would require ratepayers to pay for 'phantom equity costs' amounting to millions of dollars per year."[88/] Inexplicably, Staff supports the "phantom equity costs" in this case.

2. The Equity Building Mechanism Does Not Ensure That Avista Will Increase Actual Utility Equity

42 The Stipulation includes an equity building mechanism ("EBM") pursuant to which the Company will attempt to increase actual utility equity from 27% to 35% by December 31, 2007, and to 38% by December 31, 2008.[89/] The EBM contains penalties in the form of 1% automatic rate reductions if Avista does not meet the target equity ratios.[90/] The Company has not, however, disclosed any plan to increase its common equity utility capital. Absent a firm commitment from Avista that it will achieve the equity ratio targets in the Stipulation, the EBM should be given little weight.[91/]

43 As Mr. Gorman has explained, one of the problems with the EBM is that it does not require Avista to devote revenues to actually increasing its common equity ratio. "It is entirely possible that the Company could use this rate increase to fund increases to dividends, which is in direct contradiction to the objective of reducing debt."[92/] Avista's witness Malyn Malquist even admitted that the Company's preference is not to use the proposed rate increase to address basic issues such as reducing the ERM deferral balance as opposed to funding dividends:

87/ Exh. No. 344 at 4:22-24 (Gorman Rebuttal); Exh. No. 346.
88/ WUTC Docket Nos. UG-040640 et al., Order No. 06 at ¶ 22 (internal footnotes omitted).
89/ Exh. No. 1 at 12:14-16 (Settling Parties).
90/ Id. at 13:14-21.
91/ Exh. No. 331 at 10:4-10 (Gorman Direct).
92/ TR. 465:24 – 466:9 (Gorman).

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"[I]f we have to allocate some of the rate increase toward building down the deferral mechanisms, I think—I actually think that that makes it more difficult for us to issue equity in the marketplace, because it will have a detrimental impact on our stock price."[93/]

44 If the Commission accepts the Stipulation, it should condition acceptance on a commitment in the EBM that Avista will not increase dividends, so that Company uses all of the cash flow produced by the rate increase to pay down debt.[94/] Other jurisdictions have included similar requirements in equity building mechanisms.[95/] In addition, the Commission, should allocate to amortization of the ERM deferral balance the additional $12.4 million in revenues that results from adopting a 10.4% ROE in conjunction with a hypothetical 40% common equity ratio.[96/] Reducing the unrecovered ERM balance will reduce Avista's cost of service in future proceedings, which will, in turn, lead to lower future rates.[97/] This will not affect Avista's ability to pay down debt during the rate period, because it will not affect the increased cash flow produced by the settlement rates.[98/]

IV. ENERGY RECOVERY MECHANISM

45 ICNU recommends that the Commission reject the proposal to modify Avista's ERM in a manner that will shift additional risk (including the risk of Avista's imprudent gas acquisition strategy) to customers. The Settling Parties propose two changes to the ERM: 1) a decrease in the ERM deadband from $9 million to $3 million; and 2) a 10% increase in the ERM

93/ TR. 488:20-25 (Malquist).
94/ TR. 467:13-15 (Gorman).
95/ TR. 467:16-19 (Gorman).
96/ Exh. No. 344 at 6:1-4 (Gorman Rebuttal); Exh. No. 347.
97/ Exh. No. 344 at 6:4-7.
98/ Id. at 6:7-9.

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surcharge.[99] The proposed changes to the ERM are inconsistent with the settlement pursuant to which the mechanism was created (the "ERM Settlement") and would unjustifiably shift additional risks and costs to customers. Furthermore, the proposal to reduce the ERM deadband would force customers to bear more of the risk and cost of power cost variation at a time when Avista has increased its exposure to natural gas price risk by acquiring the second half of CS2. Avista has failed to put in place risk management policies to deal with this additional risk, despite the fact the Company knew it would be increasingly reliant on gas-fired generation after the CS2 acquisition. By requesting to reduce or eliminate the ERM deadband, Avista seeks to directly shift to customers any cost of the additional risk created by the Company.

A. <u>Reduction In ERM Deadband</u>

46 The Settling Parties make two primary arguments for reducing or eliminating the ERM deadband: 1) the $9 million deadband was developed in conjunction with a settlement related to out-of-market fixed price gas contracts that have since terminated; and 2) the Company "has no control" over power cost variations, particularly due to hydro variability.[100] These justifications provide no basis for granting the Company's request. As described below, the ERM was created as part of a settlement agreed to by Avista, Staff, ICNU, and Public Counsel to address the unique circumstances facing Avista at the time. The Commission should not upset that settlement without the agreement of all the parties or some compelling reason. No such reason has been identified in this proceeding.

47 In addition, customers have "no control" over power cost variations but, unlike Avista, customers lack the ability or opportunity to manage the cost or risk of those variations.

99/ The increase in the ERM surcharge would result in Avista collecting an additional $2.7 million a year.
100/ Exh. No. 1 at 26:2-11 (Joint Testimony); Exh. No. 81 at 29:10-18 (Peterson Direct).

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The evidence demonstrates that Avista has failed to prudently manage its gas supply at a time when the Company has substantially increased its gas supply needs by acquiring the second half of CS2. The reduction in the ERM deadband will only ensure that customers will bear the additional risk related to the Company's imprudent actions.

1. The ERM Deadband Was Agreed to in an Uncontested Settlement That the Commission Should Not Modify

48 Avista's and Staff's claim that the ERM deadband was developed solely to address the Company's above-market gas purchases is false. The ERM was a stipulated mechanism agreed to as part of a settlement of a broader group of issues in Avista's 2001 rate case, and it is incorrect to attribute the size of the deadband to any one particular issue. Staff identified the factors that lead it to accept this compromise in its 2002 memorandum explaining the ERM Settlement:

> As explained on pages 6-7 of Stipulation, ¶ II.3 a "Company Band" of $9 million annually is created under the ERM. This means that if the power supply costs tracked by the ERM that exceed the "base" costs for those accounts by less than $9 million in one year, and no power costs are added to power cost deferral balances and no rate change occurs.
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> * * *
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> The Energy Recovery Mechanism required compromises from all parties. Staff's interests included imposing sufficient risk on the Company to justify the existing return on equity, placing incentives on the Company to maintain good power purchasing practices, and giving the Company the flexibility to manage its power portfolio as it sees fit. Staff believes the proposed ERM accomplishes these goals.[101/]

Staff identified placing risks and incentives on the Company as reasons for the deadband, but noticeably absent from Staff's explanation is a statement indicating the ERM deadband should

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[101/] Exh. No. 7 at 9, 10-11.

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be changed once Avista's above-market gas purchases terminate.[102] Likewise, the Commission order approving the ERM settlement does not state that the deadband was designed to deal with out-of-market contracts.[103]

49 The ERM was the product of an agreement between Avista, Staff, ICNU, and Public Counsel and it is improper to modify a stipulated mechanism that was intended to address power cost variations on an ongoing basis without the consent of all the parties to that agreement. Although the ERM Settlement did not preclude Avista from making a request to modify the ERM, it did provide that if the Company did so, it would "have the burden of demonstrating that it is in the public interest that the ERM should continue, or be modified, and that any proposed changes by the Company to the ERM are in the public interest."[104] Avista has provided no evidence or explanation in this proceeding to justify reducing the ERM deadband or to demonstrate that doing so is in the public interest.

50 The ERM was established to provide a mechanism to address the costs and benefits of the power cost variations that the Company experiences as part of doing business. In Avista's 1999 rate case, the Commission described such mechanisms as follows:

> Rate making mechanisms that make automatic adjustments to rates for water or other cost factors impose a risk on customers. If we are to depart from our traditional rate making based on known and measurable costs and historical test years, new mechanisms must have a reasonable expectation of balance between risks imposed on the Company and those imposed on the customers. That balance must reflect the relative positions of the Company and its customers to respond, manage, or mitigate the risks they bear.[105]

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[102] Staff stated in this Memorandum that the ERM "sharing bands" addressed Avista's gas purchases "in a meaningful way" but did not state that the gas purchases were the basis for those sharing bands. Id. at 15.

[103] WUTC v. Avista, WUTC Docket No. UE-011595, Fifth Supp. Order (June 18, 2002).

[104] Id. at Appendix A, ¶ 4.c.

[105] WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 165.

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In rejecting the particular mechanism that Avista proposed in that case, the Commission stated that "[m]echanisms that simply shift risk from shareholders to ratepayers without compensating benefits do not meet this objective."[106/]

51 The proposal to reduce the ERM deadband merely takes an existing PCA and alters it in a manner that shifts risk from shareholders to ratepayers without providing any compensating benefits. As described below, Avista has exposed customers to significant risk by leaving unhedged 60% of its gas position for 2006 and by failing to formulate a prudent gas supply strategy in general. The risks of that imprudent action are legitimate, and reducing the ERM deadband merely shifts that risk to customers.

52 In addition, reducing the deadband after Avista has been operating under the $9 million deadband for only three years will not, as the Commission noted in Avista's 1999 rate case, provide a "reasonable expectation of balance between risks imposed on the Company and those imposed on the customers."[107/] The current balance of the ERM deferred account is $100 million.[108/] Reducing the deadband will only make the balance bigger.

2. Lack of Control Over Streamflows Does Not Excuse Avista's Failure to Prudently Manage its Gas Supply Risk and Does Not Justify Reducing the ERM Deadband

53 Avista and Staff ask the Commission to reduce the ERM deadband because power cost variations are the result of certain factors over which the Company "has no control," but this claim is only partially true. Avista may lack control over precipitation and other factors that affect hydro production, but the Company has the ability to manage the risk of exposure to

106/ Id. at ¶ 185.
107/ WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 165.
108/ TR. 152:19-20 (Braden).

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power cost and gas price variability, and it is required to prudently do so in order to protect customers. The evidence in the record demonstrates that Avista has failed on this point. Avista has not established a prudent strategy for procuring its gas supply or managing its gas price risk and has exposed itself and customers to significant risk of excessive costs as a result.

54 The evidence in the record demonstrates that Avista's tools for managing its gas supply risk are primitive in relation to other utilities, and Staff's power cost witness admitted at the hearing that he "would be happier" if Avista pursued certain basic practices to examine future gas prices.[109/] Avista has a significant open position in terms of gas supply for the rate year, does not attempt to model future gas prices, and does not have an up-to-date risk management policy that governs the Company's activities in the market. When PSE attempted to manage its gas supply for the Tenaska plant according to similar practices, the Commission ordered a substantial imprudence disallowance in response to PSE's actions.[110/] The Commission should not shift additional power cost risk to customers by reducing the ERM deadband under these circumstances. Reducing the ERM deadband when Avista has placed itself in virtually the same situation as PSE will insulate the Company from its own imprudent actions and unjustifiably shift the cost of those actions to customers.

a. The Commission Determined the Standard for Prudent Management of Gas Supplies in Docket No. UE-031725

55 In PSE's 2003 power cost only rate case, the Commission ordered a substantial imprudence disallowance as a result of PSE's failure to manage the gas supply of its Tenaska plant according to any comprehensive purchasing strategy. This order followed a long history

109/ TR. 214:12-13 (McIntosh).
110/ WUTC v. PSE, WUTC Docket No. UE-031725, Order No. 14 at ¶ 91 (May 13, 2004).

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associated with the Tenaska plant and its fuel supply costs. In 1997, PSE had requested that the WUTC authorize a buy out of PSE's Tenaska fuel supply contract for $215 million and create a regulatory asset to compensate for the buyout cost.[111/] PSE argued that once it bought out the Tenaska contract, and assumed responsibility for the gas supply, it could manage that supply at a substantial cost savings. The Commission approved PSE's request on that basis.

56 By 2003, the savings from PSE's management of the gas supply had not materialized. In response to evidence provided by Staff, Public Counsel, and ICNU, the Commission found that PSE had managed the gas supply for short-term gain since 1997 instead of minimizing costs for the benefit of customers. The Commission found that PSE had been imprudent in failing to develop a comprehensive strategy to address the increased gas price risk to which the company had exposed itself and customers by assuming responsibility for the Tenaska gas supply:

> By the time of the test-year, it was obvious in the marketplace, and should have been clear to PSE, that any prudent policy for gas acquisition must spread the risk of price volatility to significantly dampen its potential effects on total costs . . . . It is clear to us that during the test year PSE did not have a prudent purchasing strategy in place. Instead of developing a comprehensive strategy and a balanced approach considering opportunities in short-term, intermediate-term, and long-term gas markets, PSE simply continued its practice of buying in the short-term market.[112/]

b. Avista Acquired the Second Half of CS2 Without a Prudent Gas Purchasing Strategy in Place

57 Avista agreed in October 2004 to purchase the second half of CS2 from Mirant Corporation for a price of $62.5 million, and the Company assumed ownership of that share of

111/ Id. at ¶ 15.
112/ Id. at ¶ 91.

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the plant on January 20, 2005.[113/] The evidence in the record demonstrates that CS2 consumes approximately 43,000 dth of gas per day at its full 280 MW output.[114/] Staff's power cost witness acknowledged that only a "very small amount" of Avista's gas supply risk for the rate year was hedged at the time the Stipulation was executed.[115/] In fact, Avista's gas position for 2006 was 60% unhedged at the time of the hearing.[116/] PSE's unjustified reliance on the short-term market for the Tenaska gas supply was one of the primary criticisms leveled by the Commission. Avista appears to be following a similar strategy.

58 Avista does not have certain basic elements of a comprehensive gas supply strategy. For example, Avista does not have a programmatic hedging strategy in place to mitigate its gas supply risk.[117/] Furthermore, Avista relies solely on forward electricity and gas prices that are currently available for use in managing gas supply and "does not attempt to model potential future gas or electric price changes."[118/] Avista does not use any fundamentals analysis to determine how to supply gas for electric generating resources.[119/] Finally, in response to a data request asking for discussion of "any algorithm or technique used to decide on the benefits and costs of being short of gas in future trading conditions," Avista responded that it "does not have any algorithms or techniques to choose between spot gas purchases and longer term gas purchases."[120/] This indicates that Avista has no real method to analyze the value of a short-term purchase as opposed to a longer-term arrangement. Staff's power cost witness stated that he

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113/ Exh. No. 81 at 14:2-6, 19-20 (Peterson Direct).
114/ Id. at 26:22 – 27:2.
115/ TR. 206:17 (McIntosh).
116/ TR. 595:3-5 (Peterson).
117/ TR. 209:13-15 (McIntosh).
118/ Exh. No. 96C at 1.
119/ TR. 213:18-24 (McIntosh).
120/ Exh. No. 98.

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"would be happier if [Avista] had some such techniques" in place.[121/] In fact, it is imprudent that Avista does not.

59 Avista put forth the blanket claim in response to data requests regarding the Company's gas purchasing strategies that it manages "the purchase and sale of natural gas for gas-fired generation . . . to minimize the total power supply expense to the Company while operating in accordance with the Company's risk management guidelines."[122/] The evidence in the record, however, demonstrates that the risk management guidelines that Avista claims to be operating in accordance with are outdated and inadequate. Indeed, the risk management policy that Avista provided in discovery was dated November 9, 2000.[123/] Although a Company witness claimed at hearing that Avista had "worked on revisions to this policy," the revisions that the Company subsequently provided were of little substance.[124/]

c. Staff Did Not Evaluate Avista's Risk Management Policy Prior to Agreeing to Reduce the ERM Deadband

60 The Commission cannot rely on the fact that Staff has agreed to reduce the ERM deadband as an indication that this change is reasonable in terms of the risk facing Avista, because the testimony at the hearing demonstrated that Staff did not examine Avista's gas purchasing strategy or risk management practices in association with reviewing the CS2 acquisition. Both Staff's and Avista's power cost witnesses agreed at the hearing that Avista's acquisition of the second half of CS2 increases the Company's exposure to gas price risk.[125/] Nevertheless, Staff did not evaluate Avista's overall risk management strategy for gas used in

121/ TR. 214:12-14 (McIntosh).
122/ Exh. Nos. 96C, 97, 98.
123/ Exh. No. 96C at 3.
124/ See Avista Response to Bench Request No. 6 (Oct. 21, 2005).
125/ TR. 205:8-11 (McIntosh); TR. 594:4-7 (Peterson).

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electric generation, did not examine Avista's strategy for supplying gas to CS2 during the rate year, did not determine whether Avista's risk policy represented a prudent strategy for hedging gas risk in general, and did not conclude that Avista's risk policy represented a prudent strategy for hedging gas risk with respect to CS2 in particular.[126/] Without such a review, there is no indication that Avista has prudently fulfilled its gas supply needs for the rate year.

B. Increase in ERM Surcharge

61 Reducing the ERM deferral balance should be a priority for the Commission. Nevertheless, the ERM established the surcharge for customers, and ICNU objects to increasing the ERM surcharge in a manner that is inconsistent with the ERM Settlement. Avista has not, as the ERM Settlement required, demonstrated that this change to the ERM is in the public interest. Reducing the deferral balance should not come at the expense of Avista customers who already have experienced substantial rate increases associated with the Company's poor financial performance in the past. The evidence in the record indicates that the current deferral balance is approximately $100 million and that customers have been paying a surcharge related to this deferred account since 2001.[127/] Increasing the surcharge, along with reducing the deadband, places an unjustified additional financial burden on customers at a time when Avista's financial condition is significantly improving. ICNU suggests that the most appropriate manner to reduce the ERM deferral balance is to allocate any rate increase approved in this proceeding to that purpose.

[126/] TR. 208:13-15, 209:5-7, 211:17 – 212:2 (McIntosh).

[127/] TR. 152:18-20 (Braden).

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C. Future of the ERM

62 If the Commission agrees that modifying or eliminating the ERM in this proceeding is appropriate, ICNU recommends that the Commission terminate the ERM effective January 1, 2006. The ERM was approved to provide Avista additional protection from power cost variation in a period of market instability in order to improve the Company's financial condition.[128/] The evidence demonstrates that Avista's financial condition has improved and that the market conditions that originally justified the ERM no longer exist. As Mr. Falkenberg testified at the hearing, it is preferable as a policy matter to eliminate the ERM, use a filtered water approach to hydro modeling, and deal with extreme hydro events through deferral mechanisms.[129/]

63 In the alternative, ICNU recommends that the Commission reject the proposed modifications to the ERM and encourage the parties to further discuss the mechanism. Avista's agreement in the Stipulation to begin discussions regarding the ERM prior to December 1, 2005, reflects its willingness to consider the future of the mechanism in timely manner.

V. REVENUE REQUIREMENT

64 ICNU and Public Counsel propose a number of adjustments to Avista's revenue requirement, most of which focus on the Company's proposed power costs. In this case, Avista's initial filing requested a $28.5 million increase in power supply costs, which amounted to almost 80% of the total $35.8 million revenue requirement increase requested by the Company.[130/] The Stipulation reduced Avista's requested Washington power supply costs by

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128/ WUTC Docket No. UE-011595, Fifth Supp. Order at ¶ 7.
129/ TR. 670:15-25 (Falkenberg).
130/ Exh. No. 301C at 5:9-13 (Falkenberg Direct).

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less than $1 million.[131/] In contrast, ICNU has proposed approximately $14.0 million in adjustments to Avista's Washington power costs, none of which are accounted for in the Stipulation. In short, the Stipulation power costs substantially overstate the appropriate level of normalized power supply expenses for Avista during the rate year.

65 The testimony of Staff witness Hank McIntosh at the hearing demonstrated that Staff did not perform a detailed review of Avista's power costs before entering into the Stipulation, and that Staff settled the case prior to receiving responses to data requests regarding key power cost issues.[132/] Staff's testimony also revealed that Staff performed no significant scrutiny of Avista's Aurora power cost model or the manner in which Avista modified the model to tailor it to the Company's system, despite the fact that this is the first time that Avista has used Aurora to set retail rates.[133/] Furthermore, Staff has stated its wholesale disagreement with all of the adjustments proposed by ICNU, but Staff failed to offer any evidence or analysis demonstrating that it actually reviewed those adjustments or why the adjustments are inappropriate.

66 In contrast to Staff, ICNU presented testimony from a noted expert on power cost modeling, who thoroughly examined Avista's power costs and the Aurora model. Based on that review, ICNU offers the power cost adjustments identified below.

131/ Id. at 4, 5:14-16.
132/ TR. 230:4-8 (McIntosh).
133/ TR. 204:23-25, 205: 2-3 (McIntosh).

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A. ICNU Adjustments

1. Hydro Normalization

67 Avista relies on hydro generation for approximately 52% of its total system load, and the amount of normalized hydro generation assumed in Avista's Aurora production cost model has a significant impact on overall power supply costs.[134/] To the extent that Aurora assumes hydro generation is unavailable to serve load, the model replaces that generation with more costly resources, increasing the overall power cost forecast. Under these circumstances, developing accurate assumptions regarding hydro generation is essential to establishing just and reasonable rates.

68 The Commission should adopt an approach to hydro modeling that accurately represents normalized hydro conditions, while fairly balancing risks between customers and shareholders. In this case, there are two basic issues to decide with respect to selecting the appropriate water year study: 1) whether years that reflect extreme hydro conditions, both good and bad, should be "filtered" or excluded; and 2) the correct years to be used. The 40-year "filtered water" study supported by ICNU and Public Counsel is by far the superior choice.[135/] The 60-year unfiltered water study that is the basis for the power costs in the Stipulation is inconsistent with any of the Commission's previous decisions on this issue. Adopting ICNU's hydro normalization adjustment results in a $5.4 million reduction to Washington power supply costs.

134/ Exh. No. 301C at 6:13-14 (Falkenberg Direct).

135/ Public Counsel supports using a 40-year filtered water study using the data from 1949-1988. ICNU has supported use of the 1939-1978 data set, but agrees that either result is acceptable if the results are "filtered."

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a. Multiple Water Year Scenarios Provide an Indication of Normalized Hydro Conditions Over Time

69 The amount of available hydroelectric energy is a function of hydro conditions, which vary according to snowpack, snowmelt, run off, and precipitation.[136/] Using multiple water years helps reflect the variation in hydro conditions over time, which can be used to estimate future normalized hydro conditions. Because data from different time periods will represent historic conditions differently, the time period used will directly impact power costs. For example, Avista's evidence demonstrates that power costs in this case will differ by as much as $9 million depending on whether a 40, 50, or 60-year study is used.[137/]

b. The 60-Year Study in Avista's Initial Filing Conflicts with the Commission's Decisions on Hydro Normalization

70 In its initial filing, Avista modeled hydro generation using the 60 years from 1929-1988. Using this data set inflates power costs and conflicts with both the historic policy and more recent decisions of this Commission. Although the Commission's recent decisions do not establish a definitive policy to follow, the one consistency in all of these decisions is the lack of approval for using the 60-year average without modification. As such, there is no basis to adopt power costs based on an unadjusted 60-year study in this proceeding.

i. The Commission Adopted a 40-Year Rolling Average in 1993

71 In 1993, the Commission rejected Puget Sound Power and Light's ("PSP&L") proposal to use a 50-year study from 1929-1987, unequivocally declaring a policy to use a 40-year rolling average for hydro normalization:

136/ Id. at 6:23-24 – 7:1.
137/ Id. at 7:20-22; Exh. No. 171 at 7.

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> The Commission accepts the Commission Staff position, and directs the company to continue to use a 40-year rolling average . . . . The company is put on notice that this will remain the Commission's position on this issue unless and until a clear and convincing argument supports a superior alternative.[138/]

The 40-year rolling average remained the Commission's policy until recently, although the Commission's most recent decisions have left open the issue of the appropriate water year study.[139/]

ii. The Commission Approved Staff's 50-Year Unfiltered Water Study in the Recent PSE Rate Case

72 The Commission revisited the water year issue in PSE's recent rate case.[140/] PSE had proposed to use a 60-year water study covering 1928-1987, but the Commission ultimately adopted Staff's recommendation to use a 50-year average from 1928-1977.[141/] Staff had argued that using the full 60 years of data was inappropriate because the most recent 10 years of data did not account for non-generation uses.[142/] PSE agreed to Staff's proposal to use the 50-year average, and the Commission ultimately approved that proposal.[143/] In doing so, the Commission departed from its 40-year rolling average policy, finding that Staff had demonstrated that the 50-year average was a superior alternative based on statistical analysis.[144/] The Commission invited additional debate on this issue, however, encouraging parties "to

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138/ WUTC v. PSP&L, WUTC Docket Nos. UE-921262, UE-920433, and UE-920499, Eleventh Supp. Order at 43 (Sept. 21, 1993).

139/ For example, in Avista's 1999 rate case, the Commission adopted a settlement that used the average of values from the 60-year study and the 40-year rolling average. WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶¶ 146-47.

140/ WUTC Docket Nos. UG-040640 et al., Order No. 06 at ¶¶ 130-31.

141/ Id.

142/ Id. at ¶ 125.

143/ Id. at ¶¶ 125, 130.

144/ Id. at ¶ 130.

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continue their discussions of this subject and their efforts to develop even more rigorous tools for hydro normalization."[145/]

iii. The Commission Approved Staff's 40-Year Filtered Water Study in the Recent PacifiCorp Rate Case

73 Just over three months prior to the PSE decision, the Commission approved a 40-year "filtered water" study for setting normalized power costs in PacifiCorp's rate case.[146/] That study also was proposed by Staff and agreed to by the utility, but it differed significantly from the 50-year study. The 40-year filtered water study relied on a 40-year average from 1939-1978, but excluded "outlier" water years that were more than one standard deviation beyond the mean annual generation.[147/] Staff witness Alan Buckley explained that the basis for the 40-year filtered water method was that "there is no need to burden Washington customers with rates designed to recover long-term extremes in power supply costs due to stream flow variations. In the event an extreme year occurs that adversely affects power costs between now and the next general rate case, the Company can make a filing to recover those costs."[148/] Avista may recover certain costs associated with power cost variation through the ERM, and the Commission has approved deferred accounting to address these types of costs in the past. Mr. Buckley concluded that, under the circumstances such as these:

> It is therefore unnecessary, and even incorrect, to include the power supply costs associated with all water year conditions in the determination of the base power supply costs when a hydro adjustment mechanism exists. The effects on power supply expense of water years above or below some level can be addressed in the mechanism.[149/]

145/ Id. at ¶ 131.
146/ WUTC v. PacifiCorp, WUTC Docket No. UE-032065, Order No. 06 (Oct. 27, 2004).
147/ Exh. No. 303 at 3-6.
148/ Id. at 5.
149/ Id. at 4.

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The Commission ultimately adopted this methodology as part of a settlement.[150]

c. The Stipulation Power Costs Are Based on the 60-Year Water Study

74 The PSE and PacifiCorp cases leave open the question of the appropriate method for determining normalized hydro conditions in establishing power supply costs.[151] Nevertheless, a common theme in all the cases dating back to 1992 is that, despite the fact that utilities have proposed to use an unmodified 60-year water study on multiple occasions, the Commission has not approved normalized power costs based on such a study. Despite this fact, the Stipulation includes power costs based on a 60-year study. Although the Settling Parties purport to agree to use the 50-year unfiltered study proposed by Staff, Avista's power cost witness acknowledged at the hearing that "ultimately . . . it wasn't included in [the] settlement value."[152] As a result, the Stipulation power costs are based on an unmodified 60-year water study.

75 Regardless of the debate over this issue, there is no basis to approve normalized power costs based on a 60-year study, because there is no support for such a result in the evidence in this case or in any of the Commission's orders. Furthermore, unlike the recent PSE case, Staff provided no testimony in this case regarding the appropriate water years to use, and there is no evidence that Avista or Staff developed the more rigorous tools that the Commission recommended in the PSE case, and which Mr. Falkenberg used in this proceeding.

150/ WUTC Docket No. UE-032065, Order No. 06.

151/ Avista has argued that using the 40-year filtered water study "is inconsistent with recent decisions by the Commission" and cited the PSE order as the Commission's "precedent" on hydro normalization. As described above, the Commission approved the 40-year filtered water study on October 27, 2004, which was only three months prior to the order in the PSE rate case. There is no basis to conclude that the Commission has precluded using the 40-year filtered average.

152/ TR. 584:2-8 (Kalich).

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d. Adopting a Filtered Average Is More Consistent with Avista's ERM and Power Cost Deferred Account

76 The policy supporting the 40-year filtered water study is consistent with the Commission's decisions regarding Avista's power cost recovery in recent years. As Mr. Buckley explained in the PacifiCorp rate case, the utility's ability to request rate relief when below-normal hydro conditions occur justifies "filtering" more extreme hydro variations from data used to establish normalized hydro conditions.[153/] This point is especially relevant to Avista, because the Commission has approved both the ERM and a substantial deferred account to allow the Company to recover excess power costs due, in part, to adverse hydro conditions.

77 The Commission approved the ERM in 2002, creating a mechanism for the Company to recover the cost of normal power cost fluctuations, including those related to hydro variability. If extreme hydro conditions or power cost variations occur, however, the ERM also allows Avista to request additional rate relief. Mr. Norwood acknowledged this at the time the ERM was approved:

> [I]f you had a 100-million-dollar situation, then it would operate just as is shown here, and that is the first nine million would be absorbed by the Company. There would be a 90 percent deferral for any amount above that, and once you hit the 27.8-million trigger, we would file with the Commission to adjust rates. If the balance continues to grow, then it would be up to the Company then to come to the Commission to say that we have an extreme extraordinary situation and request the appropriate relief at that point in time, but that would be outside of this ERM mechanism. It could be done in the context of a general rate case or request for some kind of emergency relief.[154/]

153/ Exh. No. 303 at 4.
154/ WUTC Docket No. UE-011595, Fifth Supp. Order at ¶ 38.

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Mr. Buckley's "filtering" approach is appropriate under these circumstances because the "effects on power supply expense of water years above or below some level can be addressed in the mechanism," and Avista may request additional relief if extreme power cost variations occur.[155/]

78 The ability to obtain additional rate relief is particularly pertinent to Avista, because, in 2002, the Commission authorized a deferred account for the Company to recover approximately $200 million in excess power costs incurred, in part, due to below-normal hydro conditions.[156/] Avista's recovery of this deferred account balance has had a substantial impact on customers, who have been paying the rate surcharge related to the account balance since 2001.[157/] There is no basis to conclude that the Commission would be unwilling to grant relief for such conditions again in the future. These are the specific circumstances under which Mr. Buckley reasoned in the PacifiCorp rate case that it is inappropriate "to include the power supply costs associated with *all* water year conditions in the determination of the base power supply costs."[158/]

79 The Commission also should acknowledge that no power cost adjustment mechanism adopted in Washington has been permanent, and utilities have used deferred accounting on a selective basis. Notably, in the extremely good hydro years of the late 1990s,[159/] no deferral mechanism was in place; however, as hydro conditions declined, utilities sought deferrals and adjustment mechanisms. The asymmetrical use of deferrals suggests that a filtered approach is necessary to prevent over recovery of power costs over time.

155/ Exh. No. 303.

156/ Re Avista, WUTC Docket Nos. UE-011514 and UE-011595, Fourth Supp. Order at ¶ 6 (Mar. 4, 2002).

157/ WUTC Docket No. UE-010395, Sixth Supp. Order at ¶ 107.

158/ Exh. No. 303 at 4 (emphasis added).

159/ TR. 526-527 (Kalich).

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e. The Entire Available Hydro Record Confirms the Accuracy of the 40-Year Filtered Water Study

80 As described above, the two basic issues regarding hydro normalization are whether filtering should be applied and the appropriate water years to use. ICNU urges the Commission to adopt a 40-year filtered water study identical to that approved in the PacifiCorp case. Mr. Falkenberg performed significant statistical analyses in this case to verify and incorporate non-generation uses into the entire 126-year record of available hydro generation data. The results of this study demonstrate that the 40-year filtered average used by Mr. Falkenberg most closely reflects the average hydro generation and normalized power costs produced by using all available data.

i. Filtering Mitigates the Effect of Extreme Hydro Deviations on an Average Value Derived from a Limited Hydro-Year Study

81 One of the most significant differences between the 40-year filtered water study that ICNU and Public Counsel support and the 50-year unfiltered study agreed to in the Stipulation is the inclusion of the years 1929-1938, which included one of the worst multi-year droughts in the past 250 years.[160/] It is clear that Avista and the other regulated utilities in Washington have been attempting to convince the Commission since at least 1992 to use a 50 or 60-year average that would include the 1929-1938 conditions to establish "normalized" power costs. In the order from PSE's 1992 rate case, the Commission noted that PSE had argued that excluding these ten years from the determination of normalized hydro conditions "biases the average" and that "[Washington Water Power's] witness Kelly Norwood argued that a 50-year

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[160/] Exh. No. 301C at 13:11-13 (Falkenberg Direct).

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average is more reliable."[161] ICNU disagrees that the 50-year average is more reliable, and Mr. Falkenberg's analysis of the entire record of available hydro data contradicts Mr. Norwood's argument. In fact, it is only by including the years 1929-1938 that the results are inappropriately skewed in favor of lower hydro generation and higher power costs.[162]

82 Avista argues that statistical theory dictates that all data points from the 50 or 60-year hydro record can be used in this case because the data has been shown to be trendless; however, it is important to recognize that Avista is not proposing to include all available data. Rather, Avista proposes to include all values from the data set for a relatively limited number of years for which historic hydro data is available from regional hydro regulation studies.[163] Although 60 years may be the greatest number of years of this type of hydro data that is available, that still reflects only a limited snapshot of hydro conditions over time. Including an extreme hydro event such as the 1929-1938 period in a limited data set that is used to calculate an average hydro value will skew the result, unless historic hydro surpluses are included in the record to offset the impact. There is no such event in the 50 or 60-year record. The filtering method developed by Staff in the PacifiCorp rate case, proposed by Randall Falkenberg in this case, and supported by Public Counsel, provides a means of excluding extreme hydro events, both surpluses and deficiencies, from the data set in order to derive a more accurate normalized value.

161/ WUTC Docket Nos. UE-921262, UE-920433, and UE-920499, Eleventh Supp. Order at 42, 43.

162/ The Commission's order states that ratepayer groups in 1992, as they do now, argued that using the 50-year average suggested by the utilities ensure that it "only [goes] back far enough to capture the effect of the 1928-1931 drought years and thereby skew the results." Id. at 42.

163/ The Stipulation actually purports to use the average of a 50-year study, which does not include all 60 years that are available.

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83 In this case, Mr. Falkenberg performed the verification and analysis of the full set of available stream flow and generation data for the 126-year period from 1879 to 2004, and the results from this study verify that the using the 40-year filtered water study more accurately reflects hydro conditions over a longer period of time.[164/] Mr. Falkenberg's regression analyses of data provided by Avista for stream flow at Priest Rapids from 1918, from the Spokane River back to 1892, and from the Clark Fork from 1929 demonstrated that the data was highly correlated to stream flows recorded at the Dalles back to 1879.[165/] In addition, Mr. Falkenberg looked at data from tree ring studies that had been used to reconstruct stream flow at the Dalles from 1750 to 1987, which confirmed the high streamflows of the 1880s and lower flows in the 1890s that had been shown in the United States Geological Survey data provided by Avista.[166/]

84 To address non-generation uses, Mr. Falkenberg first took existing annual generation data from 1929-1988 that incorporated non-generation uses into energy production calculations and determined that the generation data was "extremely well correlated to the annual stream flows."[167/] Based on this finding, Mr. Falkenberg created a linear regression model that related annual energy production to stream flows.[168/] Using this model and the equations relating the stream flows from Priest Rapids, the Spokane River, and the Clark Fork to the streamflow at the Dalles, Mr. Falkenberg developed hydro generation values that incorporated non-generation uses for the years that such data did not already exist (1879-1928 and 1989-2000).[169/] For years

164/ Exh. No. 301C at 25:19-22 (Falkenberg Direct).
165/ Id. at 23:14 – 24:2. Mr. Falkenberg correlated data from Priest Rapids, the Spokane River, and the Clark Fork to data from the Dalles, because the data from the Dalles was available for the longest period. Id.
166/ Id. at 24:3-10.
167/ Id. at 24:13-17.
168/ Id. at 24:16-17.
169/ Id. at 24:20 – 25:6.

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that generation data did already exist (1929-1988 and 2000-2004), Mr. Falkenberg used the actual data.[170/]

85 In order to determine power costs based on these annual generation values, Mr. Falkenberg applied the power costs from Avista's Aurora model for hydro energy from the years 1929-1988 and developed a regression between power costs and annual hydro energy.[171/] This analysis once again confirmed the high degree of correlation between the values.[172/] Mr. Falkenberg determined actual power costs over the entire period 1879-2004 using the Aurora results for the years 1929-1988 and the equation derived from the regression analysis for the remaining years.[173/]

86 After verifying the data that previously had been unused and incorporating non-generation uses, the overall power cost result confirmed the result that Mr. Falkenberg is recommending in this case: the 40-year filtered water study most accurately matches the power costs and hydro generation reflected by the entire 126-year record. Mr. Falkenberg's results demonstrate that the 40-year filtered water study produces power costs in the Aurora model of $82.4 million, while the unfiltered study of the entire 126-year record produces Aurora power costs of $85.6 million.[174/] In contrast, the 60-year unfiltered study produces Aurora power costs of $90.5 million.[175/]

87 Using data from the entire 126-year record confirms that filtering the data from a more limited snapshot of hydro conditions more accurately depicts normalized hydro conditions,

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170/ Id.
171/ Id. at 25:9-10.
172/ Id. at 25:10-12.
173/ Id. at 25:12-14.
174/ Exh. No. 305 at 1.
175/ Id.

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hydro generation, and power costs over time. By either: 1) using more years of hydro data to compute the average; or 2) filtering the more extreme surpluses and deficiencies from a more limited number of years, it softens the impact of extreme hydro events on the normalized average.

ii. The Number of Water Years Is Less Important if Filtering is Used

88 Mr. Falkenberg has proposed that the Commission adopt the 40-year filtered average from the period 1939-1978 in this case, but he has testified that the actual number of years and the particular time period that is used is less significant if filtering is applied. Indeed, the evidence in the record demonstrates that actual power costs differ by only approximately $4 million if filtering is applied, depending on whether the 40, 50, or 60-year average is used. On the other hand, if the filtering approach is rejected, then the entire 126-year record should be used to set rates.

2. Hydro Shaping

89 In determining normalized power costs, the Aurora model forecasts market prices to determine the dispatch of Avista's thermal resources. Instead of allowing Aurora to dispatch its hydro resources; however, Avista has used a five-year historic average of hydro dispatch. As a result, the hydro shaping in Aurora will not accurately reflect the actual operations of Avista's hydroelectric resources. The Commission should adopt an adjustment to power supply costs to reflect more realistic assumptions about the dispatch of Avista's hydro resources. The actual operation of Avista's hydro resources is affected by factors such as load and market prices, and

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operators typically attempt to maximize the value of those resources for the system.[176/] Avista has failed to capture these dynamics in its Aurora model, inflating Avista's Washington power costs by $2.8 million.

90 The default in Aurora is that hydro output is shaped to parallel hourly load inputs, and Avista uses this method for shaping hydro resources other than the Company's own.[177/] For Avista's resources, however, the Company modifies the Aurora shaping method by using an average monthly shape based on five years of historic data.[178/] Although neither of these assumptions reflects Avista's actual operation, the modification of Aurora to dispatch the Company's hydro resources is more troubling in terms of impact on power costs, because Avista's hydro resources make up a much greater percentage of Avista's total generation than the percentage of hydro supply in the market as a whole.[179/] Further, the five-year period used by Avista includes four years when hydro was below normal.[180/] In average or good hydro years, Avista would likely have greater opportunities to dispatch hydro in response to market prices.

91 As Mr. Falkenberg demonstrated, Avista's shaping of its hydro resource dispatch based on historic averages results in a disconnect between market prices and hydro operation. Essentially, Avista's modification to the model assumes that hydro operators will not even attempt to minimize costs using hydro resources, and these results occur virtually every day of the year in Aurora.[181/] These unrealistic assumptions unnecessarily and artificially increase Avista's power costs. Furthermore, using five years of historic data for hydro resources conflicts

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176/ Exh. No. 301C at 27:18-22 (Falkenberg Direct).
177/ Id. at 27-28.
178/ Id. at 27:3 – 28:1-2.
179/ Id. at 28:3-7.
180/ Exh. No. 174 at 7:1 (Kalich Rebuttal).
181/ Id. at 28:19 – 29:2.

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with Avista's dispatch of its thermal resources in Aurora. The Company allows thermal resources to be dispatched according to Aurora's built-in optimization logic, which dispatches those resources according to a trading curve.[182/] This correlates the dispatch of those resources to market prices.

92 Mr. Falkenberg developed a method to optimize the dispatch of Avista's Clark Fork hydro resources based on market prices.[183/] This logic reflects the methodology used by other utility power cost models, including the Monet model used by Portland General Electric Company. Using this logic, Avista's hydro resources are dispatched in a manner that relates to market prices, which is consistent with the notion of maximizing the value of the hydro resources and reflects how Aurora dispatches Avista's thermal plants.

93 Avista criticized ICNU's hydro shaping adjustment in its rebuttal testimony, claiming that it is unrealistic and citing a number of factors that limit the ability to run hydro resources at maximum capacity.[184/] These criticisms are unfounded. First, Mr. Falkenberg explained at the hearing that Avista's criticism of his optimization logic that had hydro resources running at either maximum or minimum levels was unfair, "because if you look at the hourly outputs of the Aurora model . . . you will see that the same approach is used for all of the thermal units."[185/] In other words, Avista claims that Mr. Falkenberg's hydro optimization logic "has no basis in how our Company can run its system," but Avista makes the very same assumption for

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[182/] Id. at 30:2-4.

[183/] Id. at 32:5-15. Mr. Falkenberg explained that he limited the hydro optimization logic to the Clark Fork resources because the operation of the Spokane resources is typically much "flatter" than the Clark Fork resources and the Mid-Columbia resources provide much less energy. Id. at 33:3-7.

[184/] Exh. No. 174 at 15:3 – 17:17 (Kalich Rebuttal).

[185/] TR. 681:22-24 (Falkenberg).

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modeling the dispatch of the thermal units in its system.[186/] Mr. Falkenberg provided an exhibit at the hearing to show how the Company has assumed that the CS2 plant is dispatched according to this "on" or "off" dynamic in Aurora.[187/] Therefore, the "on" or "off" logic is a trait of Aurora, rather than an unrealistic assumption by Mr. Falkenberg.

94 Second, the factors that Avista has put forth as to why it cannot run its hydro resources at maximum capacity provide no excuse for assuming that the operators of those resources will not attempt to minimize costs. Mr. Falkenberg acknowledged in testimony that there are operating constraints that prevent the ability to take maximum advantage of hydro, and Mr. Falkenberg's proposed adjustment takes that into account by providing reserve capacity for spinning reserve and other ancillary services.[188/] In addition, he used only discretionary energy and dispatched the Clark Fork resources at a maximum of 460 MW, which is well below the nameplate rating of 778 MW.[189/]

95 Operating constraints apply to all types of resources.[190/] If Avista can apply the Aurora optimization logic to thermal resources, which also suffer from operating constraints, there is no basis to not apply similar logic to hydro resources as well. Furthermore, Avista admits that its hydro resources "are, on average, more flexible than the average hydro plant factor across the Northwest."[191/] Also, hydro resources are normally more flexible than thermal, because thermal units must be ramped up, rather than instantaneously dispatched.[192/] Basing hydro dispatch on historic patterns according to five years of data provides an unrealistic

186/ Exh. No. 174 at 18:7-8 (Kalich Rebuttal).
187/ Exh. No. 323.
188/ Exh. No. 301C at 29:5-7, 32:18-23 (Falkenberg Direct).
189/ Exh. No. 174 at 18:1-19:10 (Kalich Rebuttal).
190/ Exh. No. 301C at 29:5-7 (Falkenberg Direct).
191/ Exh. No. 174 at 20:7-8 (Kalich Rebuttal).
192/ TR. 770:17-19 (Norwood).

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representation of the efforts to use hydro resources to minimize power supply costs. To dispatch discretionary hydro energy to a five-year average instead of expected loads and hydro conditions would not be prudent. Therefore, setting rates on that basis is inappropriate. The Commission should adopt ICNU's hydro shaping adjustment in this proceeding and order the Company to develop its own methodology to optimize hydro dispatch for future cases.

3. Colstrip Adjustments

96 After hydro, Avista's 15% share of the Colstrip plant is its most important resource.[193/] ICNU has identified three adjustments that need to be made to the Colstrip inputs to Aurora: Colstrip capacity, timing of planned maintenance outages, and the forced outage rate.

a. Colstrip Capacity

97 The Commission should include in Avista's power supply costs the value of capacity upgrades for the Company's share of Colstrip units 3 and 4 that are planned to be completed in 2006 and 2007. Annualizing the Colstrip upgrades starting in 2006 results in a $1.4 million reduction to Washington power supply costs.[194/]

98 The evidence in the record demonstrates that the owners of Colstrip units 3 and 4 are planning a 25 MW upgrade to the unit 4 capacity for completion in mid-2006 and an equivalent upgrade to unit 3 in mid-2007.[195/] Bids have already been received for these upgrades, a vendor has been recommended to the owners, and it is likely that these upgrades will be in place during the period in which rates established in this case are in effect.[196/] Avista has stated that its economic analysis of the upgrades reveals that they are cost-effective and

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193/ Exh. No. 301C at 35:10-11 (Falkenberg Direct).
194/ Id. at 4:Table 1.
195/ Id. at 35:20-22.
196/ Id. at 36:9-12.

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prudent.[197/] In addition, Avista has been provided with a maintenance schedule for 2006 and 2007, which shows the exact dates that the upgrades will be performed.[198/] The upgrades constitute a known and measurable change.[199/] Therefore, the Commission should adopt ICNU's proposed adjustment, which annualizes the benefit of both upgrades to the beginning of 2006, as well as including the capital costs of the plants.

b. Colstrip Planned Outage Rate

99 The Colstrip planned outage rates assumed in Aurora should be adjusted because they do not accurately reflect historic or planned operation of the plant. Although the Stipulation includes an adjustment that purports to address this issue, the Stipulation adjustment should be rejected because it conflicts with historical data and is based on an analysis performed outside of Aurora. Adopting ICNU's adjustment for Colstrip planned outages reduces Avista's Washington power supply costs by $1.6 million.[200/]

100 Avista's initial filing assumed that planned outages at the Colstrip facility would be spread out evenly throughout the year.[201/] Avista admits that this was an error.[202/] The Stipulation includes an adjustment to this assumption that assigned 20% of the planned outage days to March, 30% each in April and May, and 20% to June.[203/]

101 The evidence in the record demonstrates that the forecast planned outages for 84% of the planned outage days for Colstrip will occur in May and June, and that only 16% will

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197/ TR. 545:12-15 (Kalich).
198/ Exh. No. 176C.
199/ Mr. Falkenberg has computed the rate base and depreciation adjustments necessary to reflect the fixed costs of the upgrade. See Exh. No. 301C at 4:Table 1, 36:6-7 (Falkenberg Direct).
200/ Exh. No. 301C at 4:Table 1 (Falkenberg Direct).
201/ Exh. No. 315 at 14:7-8 (Falkenberg Rebuttal).
202/ Exh. No. 174 at 21:4-10 (Kalich Rebuttal).
203/ Exh. No. 315 at 14:9-11 (Falkenberg Rebuttal).

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occur in April.[204] Thus, the Stipulation adjustment does not reflect the actual forecast of planned outages for Colstrip in 2006. The scheduling of planned outages in May and June is consistent with the assumption that planners attempt to minimize the costs of outages, because market prices typically are the lowest in May and June.[205] There is no basis to disregard this assumption in setting normalized rates, when the evidence in the record demonstrates that this is consistent with both past and future outages.[206]

102 In addition, despite the fact that the Joint Testimony supporting the Stipulation adjustment claims that the adjustment utilizes "a maintenance schedule more closely tied to historical planned outages of the plant," the evidence demonstrates that the adjustment does a poor job of representing even Avista's historic planned outages.[207] Indeed, Mr. Falkenberg provided evidence that the actual distribution of planned outages for the period 2000-2006 is 8% in March, 29% in April, 40% in May, 22% in June, and 1% in July.[208] Thus, the Stipulation adjustment overstates the planned outages assigned to March and April and understates those in May and June, when market prices are at their lowest. The result of this is to systematically overstate Avista's normalized power costs by not attempting to utilize an accurate representation of either historic conditions or actual forecast outages. The Stipulation adjustment also is an after-the-fact adjustment performed outside of the Aurora model. In contrast, Mr. Falkenberg's proposed adjustment is based on rerunning the model with his alternative maintenance periods, achieving a result that is consistent with the operation of the model itself.

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[204] Id. at 15:5-7; Exh. No. 318.
[205] Exh. No. 315 at 15:18-20 (Falkenberg Rebuttal).
[206] See Exh. No. 176.
[207] Exh. No. 1 at 19:2-3 (Joint Direct).
[208] Exh. No. 315 at 14:15-17 (Falkenberg Rebuttal); Exh. No. 318.

c. Colstrip Forced Outage Rate

103 Avista has used a five-year average for calculating the Colstrip outage rates in Aurora, which includes apparently anomalous declines in Colstrip availability in the past several years.[209/] The Company has not provided any justification for declining performance of Colstrip units 3 and 4, which are relatively new generators. ICNU recommends that the Commission adopt an adjustment that uses the ten-year average availability for the plant, which reduces Washington power costs by $0.8 million.[210/]

4. Generic Plant Maintenance

104 Similar to the planned outage rates for the Colstrip units, Avista also has not coordinated the outage rates for other generators in the Western Electrical Coordinating Council ("WECC") to the market prices produced by Aurora. As such, there is no market-wide dispatch of power plants according to market prices. Instead, Avista has used the generic outage rates that the Aurora developers included for other generators in the WECC, which assumes that all plant maintenance is scheduled during March, April, May, September, and October.[211/] As described above, Aurora has forecast low market prices during the months of May and June, and system operators typically attempt to conduct maintenance outages to coincide with periods of the lowest market prices. The generic assumptions used by Avista do not provide any benefit of maintenance outages in June. Mr. Falkenberg developed an adjustment to correct this problem, which reduces Washington power costs by $0.4 million.[212/]

209/ Exh. No. 301C at 37:11-14 (Falkenberg Direct).
210/ Id. at 4:Table 1.
211/ Id. at 38:11-16.
212/ Id. at 38:19-21, Id. at 4:Table 1.

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5. Bidding Factors

105 The Commission should reject Avista's proposed adjustment to use "bidding factors" in Aurora to attempt to align the market prices predicted by the model with Avista's actual forward curves. Avista states that it applied these bidding factors to all generators in the Western Interconnect because of a 4% difference in the Aurora market prices and the Company's forward curve over the pro forma period.[213/]

106 Avista has not provided a compelling justification for its decision to reconcile Aurora's market prices with the Company's forward price curve for the purpose of setting normalized power costs, especially given that the forward price curve has not been shown to be more accurate or a better predictor of market prices than Aurora. A forward price curve becomes outdated almost as soon as it is produced and typically reflects more near-term market phenomena that are not accounted for in a fundamentals-based model such as Aurora. When establishing normalized rates that could be in effect for several years, one goal should be to exclude short-term factors such as market psychology.[214/]

107 Avista explains that "[b]idding factors are designed to more closely align forward natural gas market prices and wholesale electric prices, which in turn ensures that Company resources are operated, as we would expect them to, given what is known about the 2006 marketplace today."[215/] The Company also states, "[a]bsent bidding factors and a correct

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213/ Exh. No. 171 at 20:19-21, 21:7-8 (Kalich Direct).
214/ It appears that Avista did not have a general rate case between 1985 and 1999.
215/ Exh. No. 174 at 23:17-19 (Kalich Rebuttal).

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representation of the relationship of natural gas and electricity, Company resources are not dispatched in a proper manner."[216/]

108 While the bidding factor adjustment in Avista's original filing was unjustified, the bidding factor adjustment in the Stipulation Aurora run suffers an even greater problem. The Stipulation updated gas prices as part of the agreed-to overall power supply costs, but the Settling Parties did not perform a parallel update to the bidding factors. Although Staff's witness stated at hearing that he did not remember if the bidding factors had been updated as part of the settlement, he did admit that not doing so could create a potential mismatch between gas and electric prices.[217/] In the Stipulation Aurora run, gas prices are based on a three-month average of prices from May, June, and July 2005, but the bidding factors are based on forward electric prices from December 2004 through February 2005. By not updating electric prices in the Stipulation, Avista compounded the very problem it was seeking to remedy through the use of bidding factors. There is no evidence under these circumstances to conclude that Avista's use of bidding factors to align gas and electric prices has achieved success. Mr. Falkenberg demonstrated that Avista's bidding factor adjustment should be excluded, reducing Washington power costs by $1.6 million.

B. Adjustments Addressed By the Stipulation

109 The Stipulation includes certain adjustments to Avista's original filing. ICNU's position with respect to those adjustments is described below.

216/ Id. at 2:30-32.
217/ TR. 225:25; 226:4 (McIntosh).

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1. Colstrip Maintenance

110 ICNU disagrees with the Stipulation adjustment related to Colstrip maintenance for the reasons explained above. The Stipulation adjustment does not reflect either the historical maintenance outages at Colstrip or Avista's expectations with respect to outages during the test year. The Commission should adopt ICNU's proposed adjustment to address this issue.

2. CS2 Fuel Adjustment

111 The Commission also should reject the Stipulation adjustment to update the gas price assumed in Avista's filing for CS2, using the 90-day rolling average for the period ending September 30, 2004. This adjustment increases the CS2 gas price assumed in Avista's initial filing to $7.25/decatherm ("dth") and increases Washington power supply costs by approximately $3.7 million.[218/] One of the problems with making this adjustment is that it assumes that Avista has undertaken an imprudent strategy for acquiring CS2 gas that relies solely on short-term gas purchases. Indeed, the $7.25/dth agreed to in the Stipulation reflects the average of NYMEX forward prices for the rate year taken only 120 days before the period in which rates proposed in this proceeding would be in effect. As a result, for this price to reflect Avista's actual supplies, the Company would have to be relying solely on short-term gas purchases to supply CS2. In Docket No. UE-031725, the Commission ordered a substantial imprudence disallowance when it found that PSE had imprudently followed a strategy of relying solely on short-term gas purchases for the Tenaska plant.[219/] The Commission should not adopt a gas price in this proceeding that reflects an imprudent purchasing strategy. In addition, the gas

218/ Exh. No. 2 at Attachment A.
219/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 91.

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prices included in the original filing reflect gas costs that the Company could have obtained, if it had a prudent purchasing strategy in place.

3. Other Adjustments

112 Except for the cost of capital adjustments discussed in Section III above, ICNU believes that the other adjustments contained in Attachment A to the Stipulation appropriately correct deficiencies in the original filing. These non-duplicative adjustments are in addition to the adjustments being proposed by ICNU and Public Counsel.

VI. RATE SPREAD/RATE DESIGN

113 Although ICNU urges the Commission to reject the Stipulation, the rate spread agreed to by the Settling Parties provides a better result than the rate spread proposal offered by Public Counsel. The Stipulation rate spread best fulfills the Commission's stated objective of moving each customer class towards "unity," while still accounting for the specific circumstances surrounding Avista's customers and the significant rate increases in recent years. Public Counsel's proposed rate spread would create disparate results between similar customer classes and could result in certain classes moving away from their cost of service. If the Commission makes a decision at this point in the proceeding that requires adopting a rate spread, ICNU recommends that the Commission approve the rate spread agreed to in the Stipulation. ICNU reserves the right, however, to request a different rate spread if the Commission rejects the Stipulation and additional proceedings are required in this case.

A. Public Counsel's Proposal Could Result in Certain Customer Classes Moving Away From the Cost of Service

114 Public Counsel's rate spread proposal is based on providing the system average increase for each customer class that falls with in a "range of reasonableness of 90% to 110% of

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parity" with respect to its "revenue to cost ratio."[220/] This "revenue to cost ratio" refers to the comparison of revenue at current rates for each class to the revenue requirement for each class.[221/] Public Counsel's "parity" concept differs from the "unity" concept discussed above, in that unity focuses on relative rates of return of each customer class, but parity focuses on a revenue to cost ratio.[222/]

115 Public Counsel's proposal results in the Residential, Extra Large General Service, Pumping, and Lighting Customer classes receiving the average system rate increase because they fall within the designated range of reasonableness of parity ratios.[223/] Small and Large General Service customers would receive slightly lower rate increases, however, because they fall outside of that range.[224/] These proposals are based on the assumption that the Commission approves an electric revenue requirement increase of $5.8 million.[225/]

116 The Commission has generally recognized in a number of cases in recent years the benefit of achieving a rate spread that moves all customer classes closer to "unity."[226/] The Commission has declined to apply a mechanical approach to establishing the appropriate rate spread in any particular case.[227/] Public Counsel's proposal could result in certain customer classes moving slightly away from cost of service without providing a basis for doing so.

220/ Exh. No. 241 at 5:30, 11:20-21 (Lazar Direct).
221/ Id. at 5:28-29.
222/ Exh. No. 351 at 6:3-6 (Iverson Direct).
223/ Exh. No. 241 at 12:8-12 (Lazar Direct).
224/ Id.
225/ Id. at 12:21.
226/ WUTC Docket No. UE-011595, Fifth Supp. Order at ¶ 26; WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 411; WUTC v. PacifiCorp, WUTC Docket No. U-86-02, Second Supp. Order at 42 (Sept. 19, 1986).
227/ WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 411.

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117 ICNU demonstrated in testimony that Public Counsel's proposal results in a discrepancy in the movement toward unity between classes, especially when that proposal is considered in relation to the $22.1 million revenue requirement increase in the Stipulation as opposed to the $5.8 million increase assumed by Public Counsel.[228/] Indeed, residential customers make the smallest movement towards unity under Public Counsel's proposal, despite the fact that those customers currently are the farthest from unity.[229/] Extra Large General Service Customers, on the other hand, make the largest movement even though those customers are closer to unity.[230/] Furthermore, the Pumping Service and Street & Area Lights schedules would receive above system-average increases even though those customers already are closer to unity than other customer classes.[231/]

118 Public Counsel's proposal effectively masks the disparate rates of return between customer classes by providing the same system-average rate increase for significantly different schedules.[232/] For example Avista's cost of service study shows that Residential and Lighting classes have rates of return of 0.61 and 1.14, respectively, but Public Counsel's proposal would result in the same rate increase for those classes.[233/] Public Counsel has not provided a justification for this inconsistent treatment among customer classes, and ICNU urges the Commission to reject Public Counsel's proposal.

228/ Exh. No. 351 at 5:15-20 (Iverson Direct).
229/ Id. at 5:22-23.
230/ Id. at 5:20-22.
231/ Id. at 5:24-26.
232/ Id. at 6:12-13.
233/ Id. at 6:14-17.

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B. The Stipulation Rate Spread Achieves a Reasonable Movement of All Customer Classes Towards Unity

119 The Stipulation rate spread results in an appropriate movement of customer classes towards unity based on each customer class' individual rate of return. Under the Stipulation, two customer classes (Residential and Extra Large General Service) receive greater than the system average rate increases, two classes receive the system average increase (Pumping Service and Street Lights), and two classes (General Service and Large General Service) receive below system average increases. Evidence provided by ICNU witness Kathryn Iverson demonstrates that most customers move roughly 23-24% towards unity under this proposal.[234/] Classes receiving the system average increase make the smallest movement towards unity.[235/] This is appropriate, however, given that these classes are already relatively closer to unity under the current rates.[236/] As a result, all customers that are not receiving the system average increase make a similar movement towards unity, unlike the disparate results produced under Public Counsel's proposal.

VII. CONCLUSION

120 The Stipulation that Avista and Staff ask the Commission to approve in this proceeding is unsupported, unexplained, and will not result in just and reasonable rates for Avista customers. The Commission has authorized substantial rate relief for Avista in the last five years in an attempt to "maintai[n] the financial stability of the Company" in the aftermath of imprudent behavior on the part of the Company's former management and the volatile wholesale

[234/] Exh. No. 351 at 4:17-18 (Iverson Rebuttal).
[235/] Id. at 4:19.
[236/] Id. at 4:20-21.

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power market conditions in 2000 and 2001.[237/] The significant efforts that the Commission made to ensure Avista's financial integrity in the recent past have allowed the Company to improve its earnings, but also have had a severe impact on customers in the form of higher rates. Avista's financial condition has now improved, and the Company's and Staff's arguments in favor of establishing rates based on a hypothetical capital structure, a reduction in the ERM deadband, and the need for the Commission to send the proper signals to the investment community have a hollow ring that is in sharp contrast to the evidence upon which the Commission authorized "emergency" rate relief in 2001. Staff entered into the Stipulation without completing discovery, without fully analyzing Avista's proposals, and without considering the testimony of ICNU and Public Counsel. When ICNU and Public Counsel filed extensive testimony supporting numerous adjustments to the Stipulation revenue requirement, Staff provided no substantive analysis addressing those proposals.

121 The Commission has no record upon which to conclude that the Stipulation is a reasonable result in this case, and ICNU requests that the Commission reject the Stipulation. In the alternative, if the Commission approves the Stipulation, it should condition approval on the Settling Parties' acceptance of the adjustments proposed by ICNU and Public Counsel, including a reduction in the stipulated ROE.

237/ WUTC Docket No. UE-010395, Sixth Supp. Order at ¶ 7.

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DATED this 14th day of November, 2005.

Respectfully Submitted,

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