[Service Date December 21, 2005]

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	DOCKET NO. UE-050482
	)	and
Complainant,	)	DOCKET NO. UG-050483
	)	*(Consolidated)*
v.	)	
	)	ORDER NO. 05
AVISTA CORPORATION d/b/a AVISTA UTILITIES,	)	APPROVING AND ADOPTING SETTLEMENT AGREEMENT WITH CONDITIONS
Respondent.	)	
. . . . .	)	

Synopsis: *The Commission approves and adopts a multi-party Settlement Agreement, subject to conditions, as a reasonable resolution of Avista's request for increases in electric and natural gas rates. The resulting increase in electric rates will allow Avista to recover up to an additional $22,135,000 in revenue. The resulting increase in natural gas rates will allow Avista to recover an additional $968,000 in revenue.*

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SUMMARY

1 **PROCEEDINGS:** On March 30, 2005, Avista Corporation d/b/a Avista Utilities (Avista or the Company) filed revisions to its currently effective Tariff WN U-28 and Tariff WN U-29 designed to effect general increases in its electric service rates (UE-050482) and gas service rates (UG-050483) in Washington. The proposed revisions provided for general rate increases of $35.8 million, or 11.4%, for the electric tariffs and $2.9 million, or 1.7%, for the gas tariffs. The Commission, by Order No. 01, suspended the operation of the general tariff revisions and consolidated the dockets for hearing.

2 **MULTI-PARTY SETTLEMENT.** On August 12, 2005, the Commission's regulatory staff filed on behalf of Avista, Northwest Industrial Gas Users, the Energy Project, and itself, a multi-party Settlement Agreement. The settlement, if approved and adopted by the Commission, would resolve all issues in the proceeding and allow for Avista to recover in rates an increase in annual electric revenue of $22.1 million (7.7%) and an increase in annual natural gas revenue of $968,000 (.6%). Public Counsel and Industrial Customers of Northwest Utilities oppose the proposed settlement.

3 **PARTY REPRESENTATIVES:** David J. Meyer, Avista VP and Chief Counsel, Spokane, Washington, represents the Company. Edward A. Finklea and Chad M. Stokes, Cable Huston Benedict Haagensen & Lloyd LLP, Portland, Oregon, represent Northwest Industrial Gas Users (NWIGU). Melinda Davison, S. Bradley Van Cleve and Matthew W. Perkins, Davison Van Cleve P. C., Portland, Oregon, represent Industrial Customers of Northwest Utilities (ICNU). Ronald L. Roseman, attorney, Seattle, Washington, represents the Energy Project. Simon J. ffitch, Assistant Attorney General, Seattle, Washington, represents the Public Counsel Section of the Washington Office of Attorney General (Public Counsel).

Gregory J. Trautman and Christopher Swanson, Assistant Attorneys General, Olympia, Washington, represent the Commission's regulatory staff (Commission Staff or Staff).[1]

4 **COMMISSION DETERMINATIONS:** The Commission determines that its approval and adoption of the proposed Settlement Agreement, with conditions, provides a reasonable resolution of the issues pending in this proceeding and is in the public interest. The end result will be rates for prospective application that are fair, just, reasonable, and sufficient.

MEMORANDUM

I. Background and Procedural History

5 Avista Utilities provides electric and natural gas service within a 26,000 square mile area of eastern Washington and northern Idaho. The company serves the following Washington counties: Adams, Asotin, Ferry, Franklin, Grant, Lincoln, Pend Oreille, Stevens, Spokane, Whitman, Klickitat and Skamania. Of the Company's 331,000 electric and 305,000 natural gas customers, 219,000 and 134,000, respectively, were Washington customers at year end 2004.

6 The Company continues its recovery from the serious financial challenges it faced in 2000 and 2001. During that period Avista experienced record low hydro conditions and unprecedented high wholesale market prices that required it to increase its outstanding debt from $715 million at December 31, 1999, to $1,175 million at December 31, 2001, in order to acquire electricity and natural gas to serve its customers. The Commission authorized Avista to establish deferral

[1] In formal proceedings, such as this case, the Commission's regulatory staff functions as an independent party with the same rights, privileges, and responsibilities as any other party to the proceeding. There is an "*ex parte* wall" separating the Commissioners, the presiding ALJ, and the Commissioners' policy and accounting advisors from all parties, including Staff. *RCW 34.05.455.*

accounts to record excess power costs not recovered in then-current rates. At the end of 2001, Avista had electric and natural gas deferral balances totaling $254 million. Avista proposed, and the Commission approved recovery of these costs over a period of time to mitigate the impact of these costs on the Company's customers.

7 The Company's credit ratings dropped in October 2001 to below investment grade in part due to the significant electric and natural gas deferrals on its books. In 2005, the Company continues to be assessed by the credit rating agencies as below investment grade for unsecured debt. Avista's total electric and natural gas deferral balances as of December 31, 2004, were $151 million on a system basis, and $122 million for the Washington jurisdiction.

8 On March 30, 2005, Avista filed tariff revisions designed to increase annual electric service revenue by $35.8 million, or 11.4%, and annual natural gas service revenue by $2.9 million, or 1.7%. The filing was based on a 2004 test period. The primary factors driving the Company's proposed electric rate increase include increases in power supply expenses and increased net plant investment, particularly Avista's recent purchase of the second half of the Coyote Springs II (CS2) project. The primary factors driving Avista's natural gas request are the cost of capital and the pro forma adjustments that were excluded from the prior settlement in November 2004 in Docket No. UG-041515.

9 The Commission suspended the operation of the tariff revisions filed in this Docket by Order entered April 27, 2005, pending an investigation and hearing concerning the proposed changes and whether they are just and reasonable.

10 The Commission conducted a prehearing conference on May 18, 2005, and established a procedural schedule. The schedule included dates for settlement discussion among the parties, dates for prefiling testimony, and hearing dates.

11 On August 12, 2005, the Commission's regulatory staff filed on behalf of Avista, Northwest Industrial Gas Users, the Energy Project, and itself (Settlement Parties), a multi-party Settlement Agreement. The settlement, if approved and adopted by the Commission, would resolve all issues in the proceeding and allow Avista to recover in rates an increase in annual electric revenue of $22.1 million (7.7%) and an increase in annual natural gas revenue of $968,000 (.6%). The Settlement Parties also filed a Joint Motion for Modification of Procedural Schedule, which the Commission granted subject to Avista's waiver of the suspension date to allow the Commission to conduct additional process if the settlement were rejected.

12 Public Counsel and ICNU oppose the proposed settlement. Both opposing parties filed responsive testimonies on August 26, 2005, that propose a number of adjustments to the Company's original case. In its responsive testimony, Public Counsel recommended an annual revenue increase of $11.7 million for electric service and an annual increase of $218,000 for natural gas service. ICNU proposed specific adjustments—most notably to return on equity and to pro forma power costs--but did not propose any final level of revenue requirement.

13 On September 22, 2005, Avista, Staff, Public Counsel, and ICNU filed rebuttal testimony. Public Counsel, in its rebuttal, adopted a number of adjustments included in the Settlement Agreement and some adjustments ICNU sponsored in its responsive testimony. Adding these adjustments to its previous recommendations, Public Counsel reduced its proposed increase in annual revenue requirement to $6.4 million for electricity and recommended a *decrease* in annual revenue of $114,000 for natural gas. ICNU did not propose any additional adjustments on rebuttal and did not propose any final level of revenue requirement.

14 The Commission conducted a public comment hearing in Spokane, Washington on October 11, 2005, and held evidentiary hearings in Olympia, Washington on October 17 – 20, 2005. The Commission heard from 26 interested persons who commented orally during the proceeding in Spokane and received 378 written comments, largely in opposition to the proposed rate increase. The Commission's formal record includes testimony by 26 witnesses, including live testimony from 22 witnesses, which produced a hearing transcript of 806 pages. The Commission received into evidence more than 275 exhibits. The parties filed briefs on November 14, 2005.

II. Proposed Settlement

15 The proposed Settlement Agreement includes the following eleven specific terms:

1) An increase of $22.1 million in Avista's annual revenue requirement for electric service and $968,000 for natural gas service. Both of these figures include the effect of the agreed-upon return on equity and overall rate of return.

2) An overall rate of return of 9.11% including a return on equity of 10.4% and a capital-structure equity share of 40%.

3) An equity building mechanism to increase the share of equity in the *utility* capital structure to 35% by the end of 2007 and to 38% by the end of 2008. Failure to meet these targets would trigger automatic rate reductions of 1% in 2008 and 1% in 2009.

4) A rate-freeze of base natural gas rates through July 1, 2007, unless Avista can demonstrate extraordinary circumstances.

5) Funding of $2.8 million per year for vegetation management and a one-way balancing account to ensure that this level of budget is expended each year, added to subsequent year vegetation management budgets, or returned to ratepayers.

6) A Company-convened work-group of all interested parties to develop a mutually acceptable approach to weather normalization.

7) Withdrawal of the Company-proposed accounting treatment for Avista's advanced meter reading project.

8) Modifications to the Energy Recovery Mechanism ("ERM") to include: reduction of the "deadband" from $9 million to $3 million annually and a 10% increase in the surcharge tariff to reduce the deferral balance more rapidly.[2] Avista also commits to initiate discussions to consider changes to the ERM by January 31, 2006.[3]

9) An agreement on rate-spread and rate-design for recovery of the additional revenue agreed to under the settlement.

10) An additional $200,000 per year of funding for low-income, demand side management ("DSM") programs for two years. An additional $600,000 per year for the Low-Income Rate Assistance Program ("LIRAP") for two years. Enhanced operational flexibility for both the DSM and LIRAP programs.

11) An Effective Date of January 1, 2006.[4]

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[2] The deferral balance referenced here is the balance of deferred power costs approved in UE 011595 for recovery over time.

[3] The original date was December 31, 2005. This was changed by an amendment filed on September 26, 2005.

[4] The original date was December 1, 2005. The amendment footnoted immediately above also changed the proposed effective date.

16 The Settlement Parties also seek the Commission's express approval of the natural gas rate limitation listed in item (4) above, and a specific finding that Coyote Springs II was prudently acquired, as part of the Commission's Order approving the Settlement Agreement.

III. Standard for Review

A. The Commission's Settlement Rules

17 WAC 480-07-750(1) states in part:

> The commission will approve settlements when doing so is lawful, the settlement terms are supported by an appropriate record, and when the result is consistent with the public interest in light of all the information available to the commission.

18 Thus, the Commission considers the individual components of the Settlement Agreement under a three-part inquiry. We ask:

(1) Whether any aspect of the proposal is contrary to law.

(2) Whether any aspect of the proposal offends public policy.

(3) Whether the evidence supports the proposed elements of the Settlement Agreement as a reasonable resolution of the issue(s) at hand.

19 The Commission must determine one of three possible results:

(1)Approve the proposed settlement without condition.

(2) Approve the proposed settlement subject to condition(s).

(3) Reject the proposed settlement.[5]

20 If the Commission approves the proposed settlement without condition, it is adopted as the Commission's resolution of the proceeding subject only to further administrative action on any petition for reconsideration, or to judicial review.

21 If the Commission approves the proposed settlement subject to one or more conditions, the Settlement Parties will have an opportunity to give notice within seven days that they find the conditions unacceptable and withdraw from the agreement. If that occurs, or if the Commission rejects the proposed settlement, our rules provide that the proceeding will return to its posture as of the day before the settlement was filed. If this occurs, the Commission will conduct further process, if any is required to allow fully adjudicated results considering the parties' respective litigation positions and due process rights.

B. Ratemaking Principles

22 The Commission is charged by statute with the responsibility to regulate in the public interest. In the context of setting rates for electric and natural gas companies, this overarching responsibility is reflected by the Commission's determination, on the basis of substantial evidence, of rates that are fair, just, reasonable and sufficient. The fair, just, reasonable and sufficient standard reflects the balance the Commission is required to strike between providing customers the lowest reasonable rates while providing the utility with rates sufficient to cover its prudently incurred costs and an opportunity to recover a return on its investment.[6] The allowed return must be adequate to allow the

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[5] *WAC 480-07-750(2).*

[6] *F.P.C. v. Natural Gas Pipeline Co.,* 315 U.S. 575, 586 62 S.Ct. 736, 743 (1942) (Constitution does not "bind ratemaking bodies to the service of any single formula or combination of formulas." As long as an agency's order "in its entirety, produces no arbitrary result, our inquiry is at an end."); *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 602-03, 64 S.Ct. 281, 287-88 (1942). A later case added that "any rate selected by the Commission by the broad zone of reasonableness permitted by the

utility to attract required capital at reasonable rates and on reasonable terms for similar companies. Stated differently, rates must be adequate to allow the utility to recover its operating expenses, maintain and service its debt, and attract equity investors by offering equity returns commensurate with what investors expect to achieve in alternative investments of comparable risk.[7]

23 A bedrock principle in utility ratemaking is that the rate setting body must achieve "end results" that satisfy the requirements discussed in the preceding paragraph.[8] In the final analysis, it is the end results, or overall results that matter, not the methods by which they are determined.

IV. Discussion and Decision

A. Settlement Process Arguments

i. Arguments on Brief in the Context of Ratemaking Principles

24 We have before us a multi-party settlement.[9] Four parties—Avista, Staff, Northwest Energy Coalition and the Energy Project—have agreed to a revenue requirement, certain underlying stipulations concerning the basis for that revenue requirement, and certain conditions, that they contend produce fair, just, reasonable and sufficient rates, terms and conditions of service. The Settlement Parties ask us to approve their agreement as a reasonable outcome supported by

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[Natural Gas] Act cannot properly be attacked as confiscatory. . . . [A]ny such rates, determined in conformity with the Natural Gas Act and intended to 'balanc[e] . . . the investor and the consumer interests,' are constitutionally permissible [citation to *Hope* omitted]. *See also People's Organization for Washington Energy Resources (POWER) v. Utilities & Transp. Comm'n*, 104 Wn.2d 798, 808, 711 P.2d 319 (1985).

[7] *Id.*

[8] *Id.*

[9] Under our procedural rules, multi-party settlement is an agreement of some, but not all parties on one or more issues. *WAC 480-07-730(3).*

substantial evidence;[10] they urge us to adopt the proposed settlement as our determination of end results that meet our statutory standard for rates and that are in the public interest.

25 Two parties—Public Counsel and ICNU—oppose the settlement. They also frame their arguments in the context of the principles discussed above. However, they also attack the settlement on the basis of the means by which the Settlement Parties reached their agreements and the circumstances surrounding the negotiations.

26 ICNU argues on brief that the settlement "is unsupported, unexplained, and will not result in just and reasonable rates for Avista customers."[11] ICNU states that the Commission has taken significant steps over the past five years to bolster Avista's financial strength and that the Company's financial condition has improved. It follows, according to ICNU, that "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."[12] In addition, ICNU argues Staff entered into the settlement without completing its discovery, without full analysis of Avista's proposals, and without responding to, or even considering the extensive testimony from ICNU and Public Counsel supporting numerous adjustments to the Company's revenue requirement.

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[10] The record includes, among other evidence, the Company's original filing and all of the Company's prefiled testimonies and exhibits, and written testimony and exhibits sponsored by Avista, Staff, NWEC, and Energy Project witnesses specifically in support of the proposed settlement.

[11] ICNU Brief at ¶120.

[12] *Id*.

27 Turning to Public Counsel's brief, the consumers' advocate argues that the settlement compromises important issues "in a 'black box' fashion."[13] Public Counsel contends, "Avista customers deserve and expect that in an era of dramatic energy cost increases, their rates will only be increased after a thorough review to ensure that no excessive or unneeded revenue is collected from customers."[14] Public Counsel argues the settlement rates are not fair, just, and reasonable. Public Counsel states it would not support any settlement of Avista's rates that does not limit the Company's return on equity to less than 10%, limit the increase in revenue requirement to $6.4 million for electric, reduce the revenue requirement for gas by $114,000, make significant changes to the ERM, and adjust rate spread and rate design to benefit residential and small commercial customers.

ii. Staff Review

28 Both Staff and Avista address ICNU's and Public Counsel's criticisms of the settlement process with discussions of prior proceedings in which the Commission has approved contested settlements, including the recent *PacifiCorp* proceeding, where the Commission approved a multiparty, nonunanimous settlement agreement, subject to conditions, "as a reasonable resolution of PacifiCorp's request for a general increase in electric rates.[15] Staff observes:

> In the *PacifiCorp* case, as in this one, the proposed settlement was opposed by both Public Counsel and ICNU. Among other contentions, those parties argued that the Commission was required to analyze and approve every individual adjustment that

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[13] Public Counsel Brief at ¶1.

[14] *Id.*

[15] Avista Brief at ¶¶8-16; Staff Brief at ¶¶22-33; WUTC *v. PacifiCorp d/b/a Pacific Power & Light Co. (PacifiCorp),* Docket No. UE-032065, Order No. 06 (October 7, 2004), *aff'd State Attorney General v. State Util. and Transp. Comm'n,* Thurston Cy. Sup. Ct. No. 04-2-02511-4 (October 27, 2005) (slip op.).

> comprised the overall revenue requirement in the parties' settlement agreement, even though that agreement clearly was the product of negotiation and compromise. The Commission disagreed.
>
> The Commission noted that the settlement agreement must be viewed as a whole, with a view to whether the "overall result in terms of revenue requirement is reasonable and well supported by the evidence."[16]

29 Staff further observes:

> As in this case, the parties in *PacifiCorp* included several individual revenue requirement adjustments as a part of the negotiated settlement. Public Counsel and ICNU argued that because these were essentially "a means to an end," – items that were a product of compromise, and hence not necessarily derived by mathematical formulas – that the settlement was somehow a "black box" that must be rejected. Again, the Commission disagreed: "This implied criticism ignores the fact that all settlements have a so-called black box quality to one degree or another – they are by nature compromises of more extreme positions that are supported by evidence and advocacy."[17]

30 Avista counters ICNU's and Public Counsel's arguments regarding Staff's review and analysis of the Company's filing, and whether Staff fully considered ICNU's and Public Counsel's extensive testimony and supporting adjustments regarding the Company's revenue requirement by quoting Staff witness Mr. Braden's testimony as follows:

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[16] Staff Brief at ¶¶28-29. *Id. PacifiCorp* Order No. 06 at ¶ 62.
[17] Staff Brief at ¶30, *PacifiCorp* at ¶61. In a footnote, the Commission also noted that "Public Counsel and ICNU have been parties to many settlements presented to, and approved by, the commission, including settlements that lack even the level of analytical detail present here." *Id*. 27, fn.52.

Q. When the Staff entered into the settlement, was it aware of the issues being raised by Public Counsel and ICNU?

A. Yes. Concerns now being raised in the testimony of Public Counsel and ICNU around a variety of issues were previously considered by Staff, before the Staff chose to enter into the Settlement Agreement. . . . In the process, Staff devoted the time and energy of several of its members to understanding the issues, auditing the books and records of the Company and examining every accounting adjustment proposed by the Company. Staff propounded 165 data requests of its own, and reviewed the Company's responses to all other requests of other parties. In so doing, it became well-acquainted with the issues and reached an informed decision that the settlement was in the public interest.[18]

31 Avista also points out that Staff considered information received in response to data requests following the filing of the Settlement Agreement.[19] In response to questioning by Chairman Sidran, Mr. McIntosh responded as follows:

Q: My question is: Did you review all of the materials that were submitted in response to these data requests, albeit they may have come in after the Settlement Agreement?

A: Yes.

Q: And did your review of these materials have [any] impact on your opinion as to the reasonableness of the settlement?

A: It confirmed my opinion.[20]

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[18] Avista Brief at ¶¶17-20, Exhibit No. 4 (Braden rebuttal) at 1.
[19] Avista Brief at ¶21, and fn. 4.
[20] Tr. at 234:16 -- 235:6.

32 The Joint Testimony provides further context for the settlement process. According to the Joint Testimony, all six parties commenced discussions for purposes of resolving or narrowing the contested issues in this proceeding in settlement conferences held on July 27 and 28, and August 3, 2005.[21] Four months of significant discovery preceded the first settlement meeting. The Company responded to 570 data requests, providing copies of its responses to all parties. The last of the settlement meetings occurred within 3 weeks of the due date for Staff and Intervenors to file their Response testimony under the original procedural schedule. Avista states that it is therefore reasonable to expect discovery to have been substantially complete and the major issues identified for purposes of settlement discussions.[22]

iii. Issues Raised by Public Counsel and ICNU

33 Avista argues that the settlement attempted to take into account a variety of issues that were raised by Public Counsel and ICNU during the settlement discussions.[23] Avista states that the Settlement Agreement expressly incorporates many issues raised by Public Counsel and ICNU, including three of Public Counsel's seven electric rate base proposed adjustments, and four out of ten of its net operating income adjustments.[24] On the gas side, the settlement incorporated all of Public Counsel's rate base adjustments and two out of three of its net operating adjustments.[25] Furthermore, the settlement included a number of

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[21] Exhibit No. 1 (Joint Testimony) at 6.
[22] *Id*.
[23] Avista Brief at ¶21.
[24] *Id*., Tr. at 793:19-25. The following seven adjustments, originally proposed by Public Counsel in its direct case were incorporated into the Settlement: (1) Colstrip 3 AFUDC rate base adjustment (electric); (2) Colstrip Common AFUDC rate base adjustment (electric); (3) Customer Deposits rate base and NOI adjustment (electric/gas); (4) American Jobs Act of 2004 NOI adjustment (electric); (5) Kettle Falls Production Tax Credit NOI adjustment (electric); (6) Amortization of Cancelled Production Facilities NOI adjustment (electric); (7) Promotional Advertising NOI adjustment (gas).
[25] *Id*. ¶

additional adjustments resulting from Staff's audit work that Public Counsel did not propose in its original direct case, but proposed in its rebuttal testimony.[26]

Commission Determination

34 Public Counsel and ICNU suggest that the Commission Staff negotiated and entered into the proposed settlement inadequately prepared because there was not sufficient opportunity for Staff to review and analyze the case before it agreed to the settlement. We disagree. Neither Public Counsel nor ICNU produced any direct evidence that supports their contention. Indeed, the direct evidence on this question supports quite the opposite determination.

35 Staff's six analysts, over the course of more than four months, reviewed extensive amounts of information including that produced as part of Avista's filing on March 30, 2005, and the Company's responses to a considerable volume of data requests during the discovery phase. Public Counsel and ICNU participated in the settlement negotiations and must have made their perspectives on Avista's case known prior to the filing of their response cases. In fact, our record shows that a significant number of the adjustments they advocated in their response cases were taken into account and expressly accommodated to one degree or another in the Settlement Agreement.

36 Staff's continuing review of discovery responses that were produced after the settlement was filed confirmed Staff's analyses and determination that the settlement terms produce end results that are in the public interest. Neither Public Counsel nor ICNU elicited any response on cross-examination that shows

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[26] Tr. at 796. These additional adjustments include (1) Pole Rental Revenues; (2) Amortized Gains on Sales of Real Property; (3) Eliminate Expiring Computer Lease Costs; and (4) a Consolidated Adjustment noted as Miscellaneous Below-The-Line Expense Elimination.

diminishment of Staff's support for any aspect of the settlement resulting from Staff's continuing review of the case in its entirety through the time of hearing.

37 The Commission's settlement hearing process in this proceeding, conducted in accordance with our procedural rules, WAC 480-07-730 – 750, has afforded Public Counsel and ICNU the opportunity to present their respective cases opposing the proposed settlement.[27] Public Counsel and ICNU had ample opportunity to complete their review of the Company's rate filing and the settlement agreement. Between them, Public Counsel and ICNU sponsored testimony by six witnesses. The opposing parties participated in four full days of hearing and were given the time they required to cross-examine all witnesses. All parties, including Public Counsel and ICNU, had the opportunity to present argument on brief in support of their positions. We are satisfied that the Commission's process for review of this multi-party settlement has produced a record from which we can determine whether we should approve the Settlement Agreement, with or without condition, or reject it. We turn to that substantive analysis below.

B. Cost of Capital

38 Avista and Staff agree to an overall rate of return of 9.11% based on a return on equity of 10.4% and a hypothetical equity share in the capital structure of 40%.[28] Compared to the Company's original filing requesting an 11.5% return on equity and an equity share of 44%, this represents an $8.7 million reduction in the electric revenue requirement and a $1.4 million reduction in the gas revenue requirement.[29]

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[27] *WAC 480-07-740 (2) (c).*

[28] Avista's currently authorized rate of return is 9.03 % set in Docket No. UE-991606. This rate of return was based on a return on equity of 11.16% and an equity share of 42%.

[29] *See* Exhibit No. 2 (Settlement Agreement) Attachments A & B.

39 The Company states on brief that this is a negotiated result, and that its willingness to accept this return on equity depends on other aspects of the settlement, including the agreed-to modifications of the ERM "deadband."[30] Staff also characterizes the 10.4% return on equity as a negotiated result.[31] Public Counsel and ICNU voice opposition both to the settlement return on equity and the hypothetical equity share. Each contends that the weighted cost of equity recommended by their respective cost of money experts is based on the "right" combination of return on equity and equity share.

i. Return on Equity

40 Avista's as-filed case included an equity return of 11.5% based in part on Dr. Avera's financial analyses. The Settlement Agreement provides for an equity return of 10.4%. Public Counsel advocates an equity return of 9.25%, based on Mr. Hill's financial analyses, and ICNU argues that 9.8% is the right equity return, based on Mr. Gorman's financial analyses.

41 Staff argues that the 10.4% settlement return on equity "is clearly a reasonable resolution of this issue" because it is halfway between the Company's as-filed 11.5% and Public Counsel's recommendation of 9.25%. Staff states that 10.4% is within the range of reasonable returns established in recent decisions in Washington and the returns recently granted utilities in other states. Staff states further that the 4.16% weighted cost of equity (return on equity multiplied by equity percentage) proposed through the settlement is lower than the 4.43% the Commission granted Puget Sound Energy (PSE) in Washington in a recent, fully litigated case; lower than the 4.43% the Idaho Public Utilities Commission recently granted to Avista in a fully litigated case; and lower than Avista's 4.95% weighted cost of equity currently approved in Oregon.[32]

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[30] Avista Brief at ¶70.
[31] Staff Brief at¶36.
[32] Staff Brief at ¶¶34-37.

42 Avista argues that the 10.4% settlement return on equity "is, by any reasonable measure, conservative when viewed against the backdrop of the evidence in this case." Specifically, Avista argues that 10.4% is lower that the authorized return on equity in Mr. Hill's sample group, which is 10.67%; lower that the average return on equity for Mr. Gorman's comparable group, which is 10.95%; and lower than the average 11.0% return for the electric utility industry Value Line expects during 2009-2010.[33] Avista argues additionally that the settlement return on equity compares favorably to the 10.36% average granted in 16 electric cases across the country, and the 10.56% granted in 8 natural gas cases during the first half of 2005. Avista, like Staff, cites to evidence showing that the weighted cost of capital (*i.e.*, 10.4% times 40% = 4.16%) that results under the settlement is less than what has been recently authorized for Avista and PSE in Idaho and Washington, respectively, following fully litigated cases.[34] Avista implies that these comparisons are particularly significant when it is considered that the Company has greater financial risk than the average risk faced by utilities in these comparisons, a factor that generally supports a higher than average return.[35]

43 Public Counsel argues that credible evidence supports its recommended 9.25% return on equity whereas there is not credible "direct evidence" supporting the 10.4% settlement return on equity.[36] Public Counsel cites Mr. Hill's and Mr. Gorman's respective financial analyses and Dr. Avera's Discounted Cash Flow (DCF) analysis result of 9.8% as providing support for Public Counsel's

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[33] Avista Brief at ¶¶30-31.
[34] *Id*. at ¶¶33, 37. *See supra,* ¶41.
[35] *Id*. at ¶39.
[36] Public Counsel Brief at ¶¶3 and 38.

argument.[37] Public Counsel contends that a 9.25% return on equity provides pre-tax interest cover of 2.27x when coupled with the 40% hypothetical equity share that Public Counsel is willing to accept.[38] Finally, Public Counsel argues that the return on equity it recommends as the highest that should be allowed is higher than the 8.4% return investor services are advising investors to expect from similar risk investments.[39]

44 ICNU argues its recommended return on equity of 9.8% is appropriate because it is the midpoint of the 8.8%, 9.8%, and 10.9% results of three analytical models (DCF, Risk Premium, and Capital Asset Pricing Model (CAPM)) used by Mr. Gorman.[40] ICNU argues that the return on equity should be set based on the results of all three models used by Mr. Gorman rather than just one, and in particular, reliance should not be solely placed on the CAPM results.[41] According to ICNU, the Settlement Parties have failed to present financial evidence to support the 10.4% return on equity and did not present an expert witness to sponsor the 10.4% return on equity.[42] ICNU contends that a negotiated result is not sufficient for setting a reasonable return on equity.[43]

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[37] *Id. at* ¶3. Public Counsel argues Mr. Hill's recommended return is within the 8.8% to 9.8% range of DCF results in this record and is within the range of Mr. Hill's risk premium analyses of 8% to 9.5%.
[38] *Id.* at ¶36.
[39] *Id.* at ¶37.
[40] ICNU Brief at¶15.
[41] *Id*. at ¶27.
[42] ICNU argues on brief that the settlement 10.4% % equity cost is not supported by evidence because it is not sponsored specifically by a cost of capital witness. This argument is unavailing. The record in this case contains ample evidence from the cost of capital witnesses, which we have considered to reach an informed judgment concerning the reasonableness of the return on equity for Avista proposed by the settlement.
[43] *Id*. at ¶35.

Commission Determination

45 Determining the proper cost of capital is an imprecise art. In particular, measuring the cost of equity capital requires the exercise of informed judgment. In contrast to the cost of debt, the cost of equity is not readily observable and must be estimated through use of theoretical financial models and corroborative evidence. In this case we have a wealth of such evidence but, unfortunately, no consensus. Dr. Avera, Mr. Hill, and Mr. Gorman offered detailed analyses and opinions, including sharp disagreements about each other's judgments, assumptions and applications of the financial models and estimation techniques. This evidence presents us with a wide range of cost of equity estimates for Avista. We find all of the experts to be credible witnesses, so our task is to determine, in light of the full body of evidence they present, whether the 10.4% return on equity proposed in the settlement is reasonable.

46 Mr. Gorman advocates that an estimate of the cost of equity is more reliable if it is based on multiple estimation techniques. We agree with this advice and apply it broadly. If consideration of a range of estimates from a single expert improves reliability, it follows that examination of a range of estimates by a number of credible experts will produce an even more robust picture of the range within which a reasonable cost of equity can be found.[44]

47 Table One shows the range of estimates developed through financial analyses included in our record.

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[44] Public Counsel also recognizes that we should look to the full body of evidence when we consider whether a particular return on equity recommendation is sound. Indeed, Public Counsel, as previously discussed, cites not only to the "direct" evidence offered by Mr. Hill in support of a 9.25% return on equity, but also Mr. Gorman's testimony supporting 9.8% and even to a portion of Dr. Avera's analysis.

TABLE ONE

	Avera Exhibit No. 50 at 40, 44	**Hill** Exhibit No. 261 at 66	**Gorman** Exhibit No. 331 at 20, 24
Recommended	11.6	9.25	9.8
DCF	9.8	9.01	8.8
CAPM	10.6 – 12.6	8.19 -9.77	10.9
Modified Earnings Price Ratio		8.34 – 8.38	
Bond Yield + Risk Premium	9.8 – 11.5		9.3 – 10.3 (mid = 9.8)
Market to Book		9.08 – 9.27	

48 The dispersion in these estimates is wide—from 8.19% to 12.6%. However, we note that results from Dr. Avera and Mr. Gorman show overlap in the middle of this range with Dr. Avera's 9.8% DCF estimate at the low end and Mr. Gorman's 10.9% CAPM estimate at the high end of that overlap. Mr. Hill's CAPM results extend to the lower end of this range. The corroborative evidence of the average of returns recently granted in other jurisdictions (10.4% for electric companies and 10.6% for gas utilities) and the average of the equity returns authorized within Dr. Hill's and Mr. Gorman's samples of comparable companies (10.7% and 10.9% respectively) also fall within this overlap.[45]

49 Considering the financial analyses presented by all three cost of money expert witnesses, and the balance of the evidence on this question, we find that the settlement return on equity of 10.4% is well-supported by the record. This level of return on equity falls comfortably within the 9.8% to 10.9% range we discuss above, and that range itself is strongly supported by the comparative evidence provided by Avista and Staff.

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[45] We give weight to the average of returns authorized in other jurisdictions as corroborative rather than primary evidence. Such evidence provides a useful check on the reasonableness of any range in cost of equity estimates derived for Avista Corporation.

ii. Equity Share

50 The settlement provides a 40% equity share in the capital structure, and includes an "Equity Building Mechanism" (EBM) that requires the utility's equity capitalization reach specific targets and ultimately achieve 38% over the next three years. Public Counsel argues that the 40% equity capitalization is appropriate for rate-setting, but not because the consolidated corporate capitalization happens to be 40%.[46] Public Counsel supports 40% as a means to "support the financial health of the Company."[47] ICNU opposes the use of 40% equity in the capital structure.

51 Avista and Staff argue a 40% equity share in the capital structure represents a reasonable compromise when considered against the 44% for which Avista offered support in its as-filed case, and when coupled with the proposed Equity Building Mechanism.[48] Avista states that a 40% equity share is below the average equity capitalization in Dr. Avera's proxy group (51.1%), Mr. Hill's proxy group (43%), and Mr. Gorman's proxy group (43%). Avista adds that the settlement would establish the Company's equity share at a level lower than the 42.59% common equity ratio recently approved in Idaho and the 48.25 equity ratio in effect in Oregon.[49]

52 Avista argues that it would be inappropriate to ignore completely Avista Corporation's capitalization and base the utility's equity share on utility capitalization alone because this would ignore the benefits of bond security diversification provided at the corporate level.[50] Avista also argues that it would be inappropriate to suspend common dividend payments until a target utility-

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[46] Public Counsel Brief at ¶44.
[47] *Id.* at ¶47.
[48] Avista Brief at ¶42, 56; Staff Brief at ¶38-39.
[49] *Id*. at ¶43.
[50] *Id.* at ¶¶45-51.

only equity share is reached because it would eliminate the Company's financial flexibility.[51]

53 Public Counsel also supports a 40% equity share for Avista, but only on two conditions. One condition is adoption of an equity return no greater than the 9.25% Public Counsel finds reasonable. The other condition is that the Commission find in its order that only capital supporting utility assets – not Avista Corporation's consolidated capital structure – deserves ratemaking consideration.[52] Public Counsel argues that setting rates based on an equity share of 40% when the utility-only equity capitalization is less than 30% constitutes a rate-payer subsidy of $5.3 million to the Company. Public Counsel accepts such a "subsidy," as being appropriately supportive of the Company's financial position.[53]

54 ICNU argues that the use of 40% equity in the capital structure is inappropriate because it does not represent the actual utility equity capitalization of 27% and would therefore allow the Company to earn an effective 12.9% return on the actual equity in the utility.[54] ICNU contends that this places the burden of building equity on customers rather than shareholders.[55] Furthermore, ICNU argues, it inappropriately imputes the capitalization of the corporation to the utility.[56] ICNU argues that allowing a 10.4% return on this "phantom equity," as would occur under the settlement, would increase the Company's revenue requirement by $12.4 million when compared to ICNU's proposed return on equity of 9.8% and equity share of 27%.[57]

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[51] *Id.* at ¶¶52-55.
[52] Public Counsel Brief at ¶49.
[53] *Id*. at ¶50.
[54] ICNU Brief at ¶37.
[55] *Id.* at ¶39.
[56] *Id.*
[57] *Id.* at ¶¶37 and 41. We note ICNU's comparison is to a 2.65% weighted cost of equity.

Commission Determination

55 We find that the settlement equity share of 40% is reasonable. The Commission has approved "hypothetical" equity components in capital structures in the past when there was a good reason to do so. In this case, our purpose is to support the Company's continuing efforts to strengthen its balance sheet and restore its credit rating to investment grade.[58] This is an important goal recognized by all parties except for ICNU. We do not accept ICNU's argument to the effect that the Commission should cease taking steps that support Avista's return to financial strength. Indeed, we have a statutory responsibility under the public interest standard to take reasonable steps to maintain the financial integrity of all regulated utilities in Washington.

56 We also reject ICNU's recommendation that we should require any authorized increase in revenue requirement be devoted to paying down the Company's deferred power cost balance. Imposing such a requirement would be contrary to the objective of enabling the utility to improve the strength of its balance sheet by buying down debt and decreasing leverage.

iii. Equity Building Mechanism

57 Under the terms of the settlement the Company agrees to an "Equity Building Mechanism" (EBM) that requires Avista to increase the "stand-alone" utility's actual equity component to 35% by December 31, 2007, and to 38% by December 31, 2008.[59] These increases in the Company's equity component are to be achieved by growth in retained earnings and reductions in outstanding levels of long-term debt.[60] According to the proposed terms of the EBM, failure to meet the common equity targets in 2007 and 2008 would result in automatic

[58] Our finding is based on this purpose and not the Company's corporate capital structure.
[59] Avista Brief at ¶56.
[60] Exhibit No. 1 at 12:14-19.

reductions in base utility rates of 1%, effective April 1, 2008, and/or April 1, 2009, respectively.[61]

58 Public Counsel and ICNU state that Avista has increased dividend payments to investors three times in the last eighteen to twenty-four months rather than retaining earnings to buy down debt. They seek assurance that Avista will use the additional revenue associated with the 40% equity share to actually build equity and not to pay additional dividends. Public Counsel advocates that the EBM be strengthened to include higher targets and higher penalties for failure to achieve those targets. ICNU urges the Commission to require that Avista commit to no increase in dividends, and that the additional $12.4 million in revenue that results from the 10.4% return on equity and 40% common equity ratio be devoted solely to paying down the ERM deferral balance.[62]

Commission Determination

59 Both Public Counsel and ICNU argue that absent strong incentive, Avista may be inclined to use its earnings to increase dividends rather than to build equity. This is a legitimate concern that we find should be affirmatively addressed. Public Counsel recommends that we increase both the equity targets and the penalties for failure to meet them.

60 Public Counsel suggests that the Commission's recent treatment of this issue in a Puget Sound Energy general rate proceeding provides useful benchmarks. We agree. The penalty in the Puget Sound Energy Mechanism for failure to meet the EBM targets is an automatic reduction in base rates of 2% spread across all classes. We accordingly condition our approval of a 40% equity share and EBM

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[61] Avista Brief at ¶56.
[62] Public Counsel Brief at ¶¶51-53, 55; ICNU Brief at ¶¶39, 42-44.

for Avista by increasing the automatic rate reduction penalty for failure to meet the EBM targets from 1%, as proposed in the settlement, to 2%.

C. Energy Recovery Mechanism (ERM)

61 The Commission established Avista's Energy Recovery Mechanism (ERM) in June 2002 by its Order approving a settlement among all parties in Docket No. UE-011595.[63] Avista, Staff, Public Counsel, and ICNU all supported the Commission's adoption of the settlement that created the ERM. Avista and Staff propose through the settlement agreement before us in this proceeding to make several changes to the ERM. ICNU and Public Counsel oppose these proposed changes.

62 The Settlement Parties propose the following changes to the ERM:

- A reduction of the "deadband" from $9 million to $3 million. The ERM currently requires Avista to absorb 100% of the first $9 million in excess power costs on an annual basis. Under the settlement proposal, Avista would absorb 100% of the first $3 million in excess costs, but only 10% of any excess costs above that level. This would also reduce the opportunity Avista has to benefit from power costs that are below the ERM baseline. Under the settlement proposal, Avista would capture 100% of power costs savings up to $3 million and 10% of any additional savings.

- A 10% increase in the surcharge by which Avista recovers excess power costs booked to the ERM deferral account. This increase amounts to approximately $2.7 million more in annual recovery of any positive deferral balance, now approximately $100 million. The purpose of this proposed change is to reduce the deferral balance more rapidly than otherwise would occur.

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[63] *WUTC v. Avista Corporation,* Fifth Supplemental Order, Docket No. UE-011595 (June 18, 2002).

- The addition of an agreement to initiate discussions with "interested stakeholders" concerning possible changes to the ERM before January 31, 2006. These discussions appear intended to complement the existing requirement that Avista make a filing with the Commission by the end of 2006. Avista will have the burden in that proceeding to demonstrate that it is in the public interest for the ERM to continue, or be modified, and that any changes proposed by the Company are in the public interest. Other parties to this subsequent proceeding will have the opportunity to propose changes to, or elimination of the ERM.

63 We determine, as discussed in more detail below, that the present record does not support the change to the deadband proposed in the settlement, but does support a ten percent increase in the ERM surcharge. We will require Avista to accelerate the formal review of the ERM by filing on or before January 31, 2006, a petition supporting continued operation of the ERM, including any changes the Company supports. Avista's filing will be in lieu of the settlement term that requires the Company to initiate "discussions" concerning the ERM by the end of January 2006. Early, comprehensive review of the ERM will provide the Commission an opportunity to consider whether continued operation of the ERM is in the public interest and, if so, whether changes to the deadband and other features of the ERM are required.

i. Changes to the ERM

a. Proposed Decrease in Deadband.

64 Avista states that it absorbed $22.5 million in losses through the deadband since it was implemented in July of 2002.[64] The Company anticipates that it will again absorb the entire $9 million deadband in 2005, given hydro electric conditions and natural gas pricing as of early fall 2005. In addition, Avista has absorbed $5.7 million through the 90/10 sharing mechanism that applies to power costs that exceed the deadband on an annual basis.

65 The Company originally proposed in its filing in this case to eliminate the deadband. The settlement, however, was a negotiated resolution of this issue, and would reduce the deadband from $9 million to $3 million instead of eliminating it altogether. As explained in the Joint Testimony:

> This reduction provides a better balancing of costs that are not within the Company's control. It also recognizes the Company's experience to date with respect to the deadband as described above and reflects a compromise of the parties' litigation positions.[65]

66 Avista states that it faces significant capital requirements in the future for investment in necessary infrastructure to serve its customers. Accordingly, Avista argues, it is important that the Commission reduce the deadband to no more than $3 million and approve the return on equity of 10.4%, as provided in the settlement. Avista contends that both the level of the deadband and the return on equity are key indicators to the investment community. If both are approved, this will assist the Company in its efforts to attract capital on reasonable terms.

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[64] *Id.* at ¶61 (citing Exhibit No. 1 at p. 27, ll. 3-7).
[65] Exhibit No. 1 at 27:19-22.

67 Public Counsel refers to the Commission's decision in an earlier Avista rate proceeding, Docket Nos. UE-991606 and UG-991607 (consolidated) for the proposition that power cost adjustment mechanisms:

> must include an equitable balancing of risk between rate payers and shareholders. *Mechanisms that simply shift risk from shareholders to rate payers without compensating benefits do not meet this objective*.[66]

Public Counsel contends the ERM settlement proposal in this case directly violates this principle by reducing the deadband without any other modifications, thus unequivocally shifting risks from shareholders to ratepayers without any compensating benefit. Public Counsel, drawing comparisons to the purchase cost adjustment mechanism the Commission authorized for Puget Sound Energy (PSE) in 2002,[67] argues that Avista's ERM is deficient in a number of ways. Public Counsel contends the Commission must address these asserted deficiencies at the same time it considers implementing other changes, such as any proposed change in the ERM deadband.

68 ICNU also argues that reducing the deadband would shift risk from shareholders to ratepayers without providing any compensating benefits. ICNU states "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." Under these circumstances, ICNU concludes, reducing the deadband does not provide a "reasonable expectation of balance between risks imposed on the Company and those imposed on the customers," an expectation

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[66] Public Counsel Brief at ¶110 (citing, with emphasis furnished, *WUTC v. Avista*, Docket Nos. UE-991606/UG-991607, Third Supplemental Order, ¶185 (2000).
[67] *WUTC v. Puget Sound Energy, Inc.*, 12th Supp. Order, Docket Nos. UE-011570 and UG-011571 (consolidated) (June 20, 2002).

the Commission previously expressed in rejecting a PCA mechanism Avista proposed.[68]

69 Avista responds that the Company, in fact, currently bears more risk relative to its customers than that borne by other utilities whose power cost adjustment mechanisms do not include a sizeable deadband. Avista argues that the financial community views the "deadband" as problematic, subjecting Avista to greater earnings volatility than occurs with similar mechanisms in place for other utilities. Avista refers us to Mr. Norwood's testimony, which quotes briefly from the Bank of America Securities Report of March 2005 ("The Kaleidoscope of Power Regulation in Focus") concerning power cost adjustment clauses in the State of Washington:

> Adjustment Clauses – Fuel and purchase-adjustments are permitted, and Puget and Avista have adjustment clauses in place. The current plans subject the utility to the risks/reward of under/over collection of a portion of the change in expected costs before costs are passed on to customers. This "dead band" approach has subjected the utilities to greater earnings volatility than a simple recovery mechanism.[69]

The Company contends that "elimination of the deadband would place Avista in a more comparable position with other utilities regarding the risk that it bears."[70]

70 In addition to its concerns about the allocation of risk, ICNU argues the proponents' contention that the deadband should be reduced because power cost variations result from factors over which the Company has no control is only

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[68] ICNU Brief at ¶¶51, 52 (quoting *WUTC v. Avista*, Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 165 (September 29, 2000).
[69] Avista Brief at ¶67 (citing Exhibit No. 11 at 15:12-18.).
[70] *Id.* at ¶69 (citing Exhibit No. 11 at 15:25-27).

partially true.[71] According to ICNU, "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 power cost and gas price variability, and it is required to prudently do so in order to protect customers."[72]

Commission Determination

71 We find that a change to the deadband without a more comprehensive examination of the ERM should not be authorized. This does not mean that such a change cannot, or will not be made during 2006. We will provide for an expedited process that will allow us to determine early in 2006, on the basis of a full record, whether there should be changes to the deadband or any other aspect of the ERM.

72 The deadband feature of the ERM has subjected the Company to greater earnings volatility than would a more simple recovery mechanism or one with a smaller deadband. It would be useful to explore in more depth whether and to what extent reducing or eliminating the deadband might reduce such volatility. We also wish to consider whether other changes to the ERM might improve the power cost recovery mechanism in ways that benefit Avista and its ratepayers.

73 Concerns about the balance of risk between the Company and its ratepayers under the ERM deserve further consideration. On the basis of a more fully developed record, we may determine that adjustments to the deadband and other features of the ERM will result in a more effective balance of risks than is currently in place.

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[71] ICNU Brief at ¶53.
[72] *Id.*

74 All parties, in one fashion or another, state support for a comprehensive review of the ERM to occur during 2006. Indeed, such a review has been planned since the inception of the ERM. The settlement approved and adopted by the Commission in Docket No. UE-011595 required Avista to make a filing by the end of 2006 for a review of the ERM.

75 The Settlement Agreement filed in this proceeding, by its terms, requires Avista to initiate discussions on this subject much sooner, by the end of January 2006. We condition our Order by requiring Avista to make a filing to initiate formal review of the ERM by January 31, 2006. This will be in lieu of the filing Avista is currently required to make on or before December 31, 2006, under the terms of our order in Docket No. UE-011595, and in lieu of simply initiating discussions as proposed under the Settlement Agreement filed in this docket.

76 We expect Staff to participate in this comprehensive review of the ERM and assume Public Counsel, a statutory party, will also participate. ICNU, and others who show a substantial interest in the proceeding, or whose participation the Commission finds in the public interest, will have the opportunity to respond to Avista's proposal and to offer their own recommendations.

77 In light of our determination that we should undertake a comprehensive review of the ERM, including further consideration of the deadband, at an early date during 2006, there is no practical reason to approve the Settlement Parties' proposal to immediately reduce the deadband.[73] Moreover, we do not find

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[73] The ERM fundamentally is an accounting mechanism. Starting anew each January 1, Avista tracks variations in its power costs above and below the ERM baseline. If, at the end of the year, the Company has experienced net excess power costs, it must "absorb" or write off the first $9 million. The Company also absorbs 10% of any excess power costs above the $9 million deadband. Avista adds 90% of any additional net excess in power costs to the ERM deferral account balance. All of these accounting issues must be resolved and reconciled as of December

adequate support in the present record for the two-thirds reduction the Settlement Parties propose. If we ultimately decide the ERM deadband should be set at $3 million or some other level, or eliminated, the practical consequences of that decision for the rate year will be accounted for in the annual reconciliation currently required as part of the ERM process.

b. Other Issues Concerning the ERM

78 There are two more issues concerning the ERM that we touch on here. Public Counsel asserts there is a "hidden" change in the ERM that would take place if the settlement is approved because Avista's as-filed case adjusts the retail revenue credit factor down from 3.739 cents to 3.399 cents, a 9.1% reduction. Public Counsel contends that this change remains in the ERM, though not addressed in the settlement, as confirmed in the cross-examination of Mr. Parvinen.[74] Mr. Parvinen stated this issue was not "deemed significant enough to warrant dealing with it in the context of the settlement."[75]

79 The monthly retail revenue adjustment used in the ERM is computed by multiplying $0.03208 per kilowatt-hour times the difference between actual and base monthly retail kilowatt-hour sales. If actual kilowatt-hour sales are greater than base, the retail revenue adjustment will result in a credit to the ERM deferral. If actual kilowatt-hour sales are less than base, the retail revenue adjustment will result in a debit to the ERM deferral. Citing historical data to which Ms. Knox referred in her testimony for Avista, Public Counsel estimates

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31, each year. Thus, any changes to the ERM we order following our review, including any changes to the deadband, will be effective for the full rate year.

[74] Public Counsel Brief at ¶113 (citing Tr. 186:4-7).
[75] *Id.* (quoting Tr. 187:1-3).

the impact of this change over two years to be in the range of $1 million to the benefit of shareholders, at ratepayer expense.[76]

80 Because the retail revenue credit calculation is part of the ERM accounting requirements, it can be adjusted at any time prior to the end of 2006 and the practical result on the deferral balance will be the same. This issue, then, can be fully considered during our near-term review of the ERM.

81 Finally, there is a significant dispute under the facts in our record concerning what Public Counsel identifies as the "production property adjustment." Public Counsel contends that this adjustment is necessary to match Avista's pro forma production rate base with its pro forma operating income included in the case. Mr. Lott testified for Public Counsel that without this adjustment Avista's fixed costs associated with production plant will be overstated on a unit basis.

82 Avista argues that the existing retail revenue credit that is part of the ERM accounts for the costs that Mr. Lott addresses with his production property adjustment. Avista argues that Public Counsel's position would be correct, but for the fact that the retail revenue credit is "an offsetting adjustment." Staff witness Mr. Parvinen agreed that the so-called production credit is already factored into the ERM.[77]

83 We do not find in the current record an adequate basis upon which to determine this matter. It does appear that there is some overlap in terms of the dollars at issue even if the principles involved in the different approaches are wholly unrelated. We can require further development of the facts in the impending

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[76] *Id.* at ¶114. Public Counsel does not explain why it would be appropriate for us to look beyond the rate year.

[77] Avista Brief at ¶¶81 – 84 (citing Tr. 199: 24 – 200: 5).

comprehensive review of the ERM and the results of our inquiry can be applied prospectively, as appropriate.

ii. Increase in Surcharge.

84 Avista, in fact, has experienced excess net power costs each year since the inception of the ERM. The balance in the ERM deferral account currently is approximately $100 million. The Commission has authorized a surcharge through which Avista recovers from its customers a portion of the outstanding balance in the deferral account each month. The level of the surcharge affects the rate at which the deferral account can be reduced to a zero balance, which would eliminate the need to continue the surcharge. In their joint testimony in support of the settlement, the sponsoring witnesses testify that "recovery of the deferral balance in a more timely manner will allow the Company to buy back more debt, build the equity component, and improve its financial health more quickly."[78]

85 The Settlement Parties propose a 10% increase in the surcharge. The current electric surcharge of 9.8%would be increased to 10.8%. This increase amounts to approximately $2.7 million more in annual recovery of the deferral balance. The impact on rates for the average residential customer using 1000 kwhs per month is approximately $0.49.[79]

86 There is scant discussion of this issue in the parties' briefs. Indeed, Avista, Staff, and Public Counsel do not address it at all. ICNU objects to the increase proposed in the settlement on the basis that the surcharge was established in Docket No. UE-011595 and should not be changed "in a manner that is inconsistent with the ERM Settlement." ICNU argues, however, that it would be

[78] Exhibit No. 1 at 28:9-11.
[79] *Id.* at 32:16-19.

appropriate to reduce the ERM deferral balance by allocating "any rate increase approved in this proceeding to that purpose."[80]

87 ICNU also argues that Avista has not shown the proposed change to be in the public interest. On the other hand ICNU states "[r]educing the ERM deferral balance should be a priority for the Commission."[81] Thus, ICNU seems to recognize that reducing the ERM deferral account balance more quickly is sound policy and, hence, does promote the public interest.

Commission Determination

88 We will approve the proposed increase in the surcharge. Concerning ICNU's argument that we should not disturb the parties' settlement agreement in Docket No. UE-011595, we observe that it is the Commission's Final Order in Docket No. UE-011595 that is controlling, not the agreement among the parties to that proceeding. The Commission has an ongoing responsibility to regulate in the public interest and cannot, in effect, delegate its responsibility to others by binding itself to the terms of a settlement agreement. The Commission retains authority to change its orders at any time on a record such as this one, which supports what we authorize here.[82]

89 The operation of the ERM that we will examine early in 2006 concerns accounting issues that are separate from the question of Avista's recovery in rates of the deferral balance through a surcharge. We are persuaded that the Settlement Parties' proposal to increase the current ERM surcharge by 10% is a change that should be authorized in this proceeding. Regardless of what action the Commission subsequently takes regarding the ERM, we know now that the

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[80] *Id.*
[81] ICNU Brief at ¶61.
[82] RCW 80.04.210.

operation of the mechanism has resulted in a positive deferral balance of approximately $100 million. The proposed surcharge increase is intended to reduce the deferral balance more quickly. Reducing the ERM deferral balance more quickly is good public policy that promotes the interest of Avista and its ratepayers.

90 We are mindful that the increased surcharge, along with higher rates that result from this Order, will burden some ratepayers. However, Avista and its ratepayers both will benefit from a smaller deferral balance on the Company's books. A slight increase in the ERM surcharge will promote that result.

91 We conclude that it is in the public interest to approve the increase in the surcharge proposed under the settlement.

D. Revenue Requirement

92 Public Counsel and ICNU propose a significant number of adjustments to the operating costs and rate base that support the revenue requirement proposed in the Settlement Agreement.[83] We have examined each of the proposed adjustments in light of the evidence presented and the parties' arguments. We considered, among other things, whether the evidence discloses any errors on the part of the Settlement Parties in the application of data or modeling that underlies the settlement.

93 The record shows that the Settlement Parties erred when they calculated two of the many values they used to develop total power costs using the AURORA model. Specifically, we find that the Colstrip planned outage rates assumed in AURORA do not accurately reflect historic or planned operation of the plant. In

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[83] Exhibit Nos. 376 (Public Counsel Response to Bench Request No. 4) and 377 (ICNU Response to Bench Request No. 5).

addition, we find that there is a mismatch with respect to two related inputs the Settlement Parties used when determining the level of power costs to be included in the proposed revenue requirement. The Settlement Parties used updated gas prices but did not update the bidding factors used to align forward natural gas market prices and wholesale electric prices.

94 We condition our approval of the settlement by requiring Avista to adjust these factors to comport with the evidence, as discussed below, and to rerun the AURORA model. We require Avista to adjust the revenue requirement underlying rates to reflect the resulting level of power costs when making its compliance filing to implement the terms of this Order.

95 We also find that the evidence does not support two *pro forma* adjustments to rate base that are embedded in the revenue requirement under the proposed settlement. The settlement does not properly or consistently pro-form the depreciation expense and deferred taxes in the 2006 rate year for Coyote Springs II or for three transmission upgrades included in a single "Pro Forma Transmission Projects" adjustment. We condition our approval of the settlement by requiring Avista to adjust these factors to comport with the evidence, as discussed below.

96 We find that the remaining settlement terms respecting revenue requirement are supported by an appropriate record. The end results achieved without further adjustment to the revenue requirement are consistent with the public interest in light of all the information available to the Commission.

i. Colstrip Planned Outages

97 ICNU argues that the Colstrip planned outage rates assumed in AURORA should be adjusted because they do not accurately reflect historic or planned

operation of the plant.[84] ICNU notes that although the Settlement Agreement includes an adjustment that purports to address this issue, the proposed settlement adjustment should be rejected because it conflicts with historical data and is based on an analysis performed outside of AURORA.

98 ICNU points out that the settlement assigns 20% of the planned outage days to March, 30% each to April and May, and 20% to June.[85] According to ICNU, the settlement overstates the planned outages in March and April and understates those in May and June, months when market prices typically are at their lowest levels.

99 Mr. Falkenberg testified for ICNU that the Colstrip outages should be scheduled to coincide with periods of lowest wholesale market prices, May and June during 2006. He reran AURORA assuming the Colstrip outages occur during those two months, concluding that the adjustment would reduce Avista's Washington power supply costs by $1.6 million.[86]

100 Avista argues that planned maintenance with respect to Colstrip has historically occurred from March through June in each year, with approximately 10% occurring in March and June and 40% occurring in the months of April and May.[87] Avista contends that Mr. Falkenberg's adjustment to have all planned maintenance simply coincide with periods of lowest wholesale prices does not comport with actual historical schedules for required maintenance. According to Avista, market conditions alone do not determine the timing of planned maintenance but rather the availability of suitable labor, specific operating

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[84] ICNU Brief at ¶99.
[85] *Id*. at ¶100,
[86] Exhibit No. 301C (Falkenberg Direct) at 4: Table 1.
[87] Avista Brief at ¶110; Ex 174 at 21:11-19.

concerns at the individual plant, and the extent of maintenance required all affect the timing.[88]

Commission Determination.

101 We agree with Avista that it is not reasonable to assume Colstrip maintenance is always timed to coincide with the period of lowest wholesale prices. We find that the Colstrip planned outage adjustment should be based on actual historical planned maintenance experience. The settlement's representation of historic planned maintenance for Colstrip, however, is not supported by the record. The evidence provided by Mr. Falkenberg, which is based on data supplied by the Company, shows 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.[89] The Colstrip planned outage adjustment should be based on this data, which we find to be the best available data in our record. It will be necessary for Avista to rerun AURORA using this information to estimate the average costs associated with planned outages at the Colstrip generating plant. We condition our approval of the settlement on this being done prior to, and in support of Avista's compliance filing.

ii. Bidding Factors

102 Bidding factors are an input to the AURORA power model designed to align forward natural gas market prices and wholesale electric prices, so that the Company's resources are operated on what it can anticipate in the 2006 marketplace.[90] ICNU argues that the Commission should reject Avista's proposed adjustment to use bidding factors.[91] ICNU contends that Avista has

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[88] *Id*. at ¶¶ 110-111.
[89] Exhibit No.318; *see also:* Exhibit No. 311.
[90] Avista Brief at ¶112.
[91]ICNU Brief at ¶105.

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. According to ICNU, 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.[92]

103 Avista states that Illustration No. 8 in Mr. Kalich's rebuttal testimony demonstrates the impact of excluding bidding factors from the analysis.[93] According to Avista, the illustration clearly shows that without the use of bidding factors the AURORA model does not properly reflect the forward market. It follows that the power supply model would then incorrectly estimate the Company's pro forma power supply expenses.

104 Avista finds support for its argument in the Commission's recognition in a recent PSE proceeding of the importance of using forward prices. In the PSE case, the Commission approved the use of 3-month averaging of forward market values. Avista states that "the Settlement Agreement makes use of a 3-month average of forward natural gas prices, consistent with this Commission's recent order." [94]

105 In addition to arguing that the bidding factor adjustment in Avista's original filing was unjustified, ICNU contends that the bidding factor adjustment in the AURORA run supporting the settlement suffers an even greater problem. Specifically, ICNU argues, the settlement updated gas prices as part of the agreed-to overall power supply costs, but the Settlement Parties did not perform a parallel update to the bidding factors.[95] ICNU is correct that in the settlement

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[92] *Id*. at ¶106.
[93] Avista Brief at ¶112; Exhibit No. 171 (Kalich Rebuttal) at 24.
[94] Avista Brief at ¶113; *WUTC v. Puget Sound Energy, Inc.*, Order No. 06 Final Order, Docket Nos. UG-040640, et al., ¶107 (February 18, 2005).
[95] INCU Brief at ¶108.

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. ICNU concludes that by not updating electric prices in the settlement, the Settlement Parties compounded the very problem Avista seeks to remedy through the use of bidding factors.

Commission Determination.

106 We find that it is appropriate for bidding factors to be included in AURORA. It is important to determine accurate estimates of actual costs that the Company will experience in the near and intermediate terms. Bidding factors, correctly applied, promote more accurate estimates for projected power supply costs. We also find the use of a 3-month average of forward prices, consistent with the methodology the Commission has previously approved, is acceptable.

107 Finally, however, we find that the Settlement Parties' failure to update the bidding factors to harmonize them with the updated gas costs on which the settlement is based is a mistake that undermines the purpose of bidding factors. We require Avista's pre-compliance rerun of AURORA to reflect our finding that updated power costs require updated bidding factors to avoid a potential mismatch between gas and electric prices.[96]

iii. Rate Base Adjustment for Coyote Springs II

108 Coyote Springs is a two-unit combined-cycle combustion turbine power plant located near Hermiston, Oregon. Avista and Mirant co-owned one of the two units, referred to as Coyote Springs II. Avista purchased Mirant's interest in Coyote Springs II in early 2005 and is now the sole owner of the unit.

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[96] Mr. MacIntosh could not recall at hearing whether the settling parties updated the bidding factors, but he acknowledged that this potential exists. Tr. 225:25; 226:4.

109 Avista's initial share of Coyote Springs II was placed in rates in the Company's most recent prior general rate case.[97] In this proceeding, Avista seeks to include in rate base the portion of the plant the Company acquired from Mirant during 2005. Although not a term of the Settlement Agreement, the Settlement Parties request in their joint testimony that the Commission expressly find in its Final Order in this proceeding that Avista's acquisition of the second half of Coyote Springs II was prudent.[98] They offer detailed testimony concerning Staff's review of the prudence question and state that "Staff is of the opinion that Avista's acquisition of the second half of CS2 was prudent."[99]

110 ICNU takes issue with the Company's gas purchase strategy for the plant, but does not contest the acquisition itself as imprudent. Public Counsel also does not challenge the prudence of the acquisition. Public Counsel, however, takes issue with the manner in which Avista pro-formed the 2005 acquisition of Coyote Springs II into rate base.

111 According to Public Counsel, Avista proposes to bring Coyote Springs II into rate base in a manner that does not properly or consistently pro form the depreciation expense and deferred taxes in the 2006 rate year. Public Counsel contends that the Company has over-stated the cost of this plant in the 2006 pro forma adjustment to rate base.[100] Public Counsel, through Mr. Lott's testimony, proposes a reduction in rate base of $1,882,000 to correct for the Settlement Parties' failure to follow the so-called matching principle that requires maintaining the relationship between rate base and net operating income consistent with the period of time chosen.[101] According to Public Counsel the

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[97] Exhibit No. 281, (Lott Direct) at 20.
[98] Exhibit No. 1 at 25.
[99] *Id.* at 24.
[100] Public Counsel Brief at ¶71.
[101] Exhibit No. 281 at page 21.

corresponding revenue requirement impact is $210,000.[102] The matching principle requires that all cost-of-service components – revenue, investment, expenses and cost of capital – must be considered and evaluated at a similar point in time.

112 Avista argues there is no mismatch. Rather, Avista states, the Company simply adjusted its capital and O&M costs to reflect 2005 data, the most recent known and measurable information. Avista relies on Mr. Falkner's testimony that:

> The benefits of dispatching the second half of CS II have been captured in the power supply model, using 2004 loads, and the O&M costs have been included on a basis that is most consistent with the first half of CS II, calendar year 2005. What this does is eliminate the need to try to predict, or project two years out, what incremental additions and retirements are going to be incurred for CS II during 2005 and 2006, and produces a known and measurable result.[103]

Commission Determination

113 We find that the *pro-forma* adjustment for Coyote Springs II should be based on the *pro-forma* level of expense to be incurred in the rate year, 2006. Avista is adding plant that was not used in the test period, was not necessary in the test year, and is only necessary for future periods. Avista's use of known and measurable information outside the rate year violates the matching principle. We find Public Counsel's proposed adjustment is supported by the record. We will require, as a condition of our approval of the settlement, that Avista reduce the electric revenue requirement by $276,000 prior to making its compliance filing, to reflect a rate base adjustment of $1,882,000 and a rate of return of 9.11%.

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[102] Exhibit No. 283. The $210,000 calculation is based on Public Counsel's recommended rate of return.

[103] Avista Brief at ¶143 (quoting from Exhibit No. 105 at 15: 4-9).

114 We also find adequate support in the record to support a finding that Avista's acquisition of the second half of Coyote Springs II was prudent.

iv. Pro Forma Transmission Project

115 Similar to the Coyote Springs II adjustment, Public Counsel proposes an adjustment that would account for the plant-in-service accumulated depreciation and deferred taxes associated with three transmission projects Avista will complete during 2005 based on what will be experienced during the rate year, 2006. Mr. Lott's adjustment reflects a *pro-forma* transmission plant investment based on 2006 average of monthly average balances.[104] Mr. Lott's adjustment would reduce *pro-forma* rate base by $215,000. Mr. Lott's calculation, using Public Counsel's proposed rated of return result in a corresponding revenue requirement reduction of $24,000.[105] Public Counsel observes that Mr. Lott's calculation, unlike that of the Company and Staff, follows the tax regulations, which require that when a projection of plant is made beyond the historical test year, plant-in-service, depreciation and deferred taxes must all be calculated on the same average.[106]

116 Avista argues that Mr. Lott's projection to the year 2006 should be rejected and, instead, 2005 information should be used. Avista contends this eliminates the need for projections of additions and retirements and produces an adjustment at a known and measurable level.[107] According to Avista, there is no mismatch associated with inclusion of these projects, and no issues with federal tax rules that would impact a decision by the Commission.

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[104] Public Counsel Brief at ¶72; Exhibit No. 281 (Lott Direct) at 22.
[105] Exhibit No. 283.
[106] *Id*.
[107] Avista Brief at ¶145; Exhibit No.105 (Falkner Rebuttal) at 16-17.

Commission Determination

117 Based on the same rationale we applied in accepting Public Counsel's Coyote Springs II rate base adjustment, we find that Avista's revenue requirement requires adjustment to satisfy the matching principle in the case of these transmission projects. Public Counsel's transmission project adjustment accounts for the plant-in-service accumulated depreciation and deferred taxes based on what will be experienced during the rate year. This is appropriate. The Company's adjustment results in a mismatch. We require, as a condition of our approval of the settlement, that Avista reduce the electric revenue requirement by $32,000 prior to making its compliance filing, to reflect a rate base adjustment of $215,000 and a 9.11% rate of return.

v. Hydro Normalization

118 The only adjustment we require with respect to hydro normalization is one Avista offers to make on brief. In its audit of the Company's adjustments, Staff used a hydro-normalization methodology based on the average of 50 separate simulations run through the AURORA model utilizing hydrological data for 50 years, from 1928-1979. This is the approach the Commission adopted in a recent Puget Sound Energy general rate case that was fully litigated.[108] The parties to the settlement agreed to use this methodology for purposes of the settlement.

119 Avista states on brief that the agreed-upon revenue requirement of $22.1 million included in the settlement, in fact, does not reflect the use of 50 years' worth of water data. According to Avista, correcting this error translates into a further

[108] *WUTC v. Puget Sound Energy, Inc.*, Order No. 06: Final Order, Docket Nos. UG-040640 and UE-040641 (February 18, 2005).

reduction in revenue requirement of $165,000. Avista states that it does not object to this further revision being ordered by the Commission.[109]

120 We find this correction should be made and condition our approval of the settlement accordingly.

121 Hydro normalization methodology is a recurring issue in the Commission's general rate proceedings. The issue centers on how to determine the annual "average" amount of river water flow and the resulting amount of hydro-generation that will be available during the rate year. This is one of the factors critical to the power cost results determined using the AURORA power cost model.

122 ICNU urges the Commission to reject the settlement's approach to hydro normalization. ICNU argues the better approach is for the Commission to use a 40-year water study, filtered to exclude what Mr. Falkenberg considers to be extreme years. ICNU contends that Mr. Falkenberg's study demonstrates that a 40-year filtered average "most closely reflects the average hydro generation and normalized power costs produced by using all available data."[110]

123 Avista, relying on Mr. Kalich's testimony, argues that there is no statistically valid reason to filter out water-years that are only one standard deviation from average. Accepted statistical theory, according to Mr. Kalich, defines so-called "outliers" in normal and trendless distributions as those occurring beyond three or four standard deviations, not one.[111] Avista points out that such filtering removes one-third of the data, and that the consequence is to produce a water-record that is biased toward high flows. We agree with Mr. Kalich's assessment.

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[109] Avista Brief at ¶89.
[110] ICNU Brief at ¶80. ICNU's use of the phrase "all available data" is a reference to the entire 126-year record of available hydro generation data.
[111] Avista Brief at ¶90 (citing Exhibit No. 174 (Kalich Rebuttal 6:1-7).

Filtering on the basis of one standard deviation from the mean is not statistically sound given that hydro data in the Pacific Northwest is known to be normally distributed and trendless.

124 The settlement relies on an approach the Commission accepted in the most recent fully litigated general rate proceeding in which this issue was considered in light of rigorous statistical analyses. The Commission found in the PSE proceeding that the "clear and convincing argument by Staff and PSE [demonstrates] that the method presented by Dr. Mariam based on 50 years of data is a superior alternative to the 40 years rolling average."[112]

125 ICNU proposes an approach that lacks a sound statistical basis and that appears to produce biased results. Indeed, Mr. Falkenberg acknowledges that his water year proposal "was not made on the basis of statistical analysis, but rather on the basis of policy considerations."[113] Mr. Falkenberg also testified with respect to the Commission's Final Order in the PSE case that he "didn't feel that anybody could improve on the statistics that were presented in that case."[114]

126 We do not find ICNU's argument persuasive on this point. The evidence in our record strongly supports the approach to hydro normalization taken in the settlement and is consistent with the Commission's decision in a recent, fully litigated case.[115] Accordingly, we require only the correction to the hydro normalization adjustment that Avista identifies in its brief, as discussed above.

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[112] *Supra.* fn. 23 Order No. 06 at ¶130.
[113] Tr. 678: 17-24.
[114] Tr. 679: 9-14.
[115] *See supra* fn. 108.

vi. Other Adjustments.

127 As an alternative to their preferred result that we reject the settlement, Public Counsel and ICNU propose that we condition our approval by requiring a significant number of adjustments to the Company's revenue requirement in addition to those discussed above.[116] We have examined each of the proposed adjustments in light of the evidence presented and the parties' arguments. While Public Counsel and ICNU would have us make different adjustments, or assign different values to certain of the adjustments made in the Settlement Agreement, we are confident in our judgment, made on the basis of the record before us, that the overall result in terms of revenue requirement is reasonable and well supported by the evidence.

128 The end results advocated by Public Counsel and ICNU, on the other hand, would not produce rates that are fair, just, reasonable and sufficient. The end results these parties advocate would fail particularly the sufficiency standard. It is most unreasonable to contend, as Public Counsel and ICNU do, that we should accept most, or all of the adjustments agreed to by the Settlement Parties and then make significant additional adjustments that would cut the agreed electric revenue requirement by more than 65% and reverse the agreed gas revenue requirement so as to require a rate decrease.[117]

129 We find that the revenue requirement included in the settlement, adjusted as we require in our conditions to this Order, is reasonable. We know the dollar impact of two of the adjustments we require. The Coyote Springs II adjustment reduces Avista's rate base by $1,882,000, which requires the electric revenue requirement

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[116] Exhibit Nos. 376 (Public Counsel Response to Bench Request No. 4) and 377 (ICNU Response to Bench Request No. 5).

[117] Public Counsel recommends that Avista receive no more than a $6.4 million electric rate increase a decrease of $114,000 in gas rates.

to be reduced by $276,000. The Transmission Projects adjustment reduces Avista's rate base by $215,000, which requires the electric revenue requirement to be reduced by an additional $32,000. The hydro normalization adjustment reduces the electric revenue requirement by another $165,000. Overall, the impact is to reduce the electric revenue requirement by $473,000 to $21,662,000.

130 We will not know until AURORA is rerun whether the revenue requirement effect of fixing the two mistaken assumptions we discuss above will be to increase or decrease power costs. Accordingly, if the rerun of AURORA that we require in connection with the Colstrip Planned Outages adjustment and the Bidding Factors adjustment increases the power costs embedded in the settlement we will allow Avista to include the increase up to the level of the $22,135,000 upon which the as-filed settlement is based. Avista is authorized, but not required to petition for recovery of any increase in power costs that would produce a revenue requirement greater than $22,135,000. On the other hand if the rerun of AURORA results in reduced power costs relative to what is included in the settlement, Avista must make that reduction in revenue requirement to the $21, 662,000, and use the result in making its compliance filing.

E. Rate Spread and Rate Design

131 Section 14 of the Settlement Agreement provides a detailed description of the spread of the proposed electric ($22,135,000) and natural gas ($968,000) revenue increases, as well as the changes to the rates within the Company's general service schedules.[118] The intent of Avista's originally filed electric rate spread methodology was to move each class approximately 33% of the way toward unity. The Settlement Agreement results in most customer class rates moving approximately 23-24% toward unity. The intent of Avista's originally filed

[118] Exhibit No. 2 (Settlement Agreement) at 5-6, and Attachment C.

natural gas rate spread methodology was a reasonable movement toward parity under the cost of service study, and the Settlement Agreement results are consistent with this intent.[119]

132 The Company used the results of its cost of service study as a guide in spreading the proposed increase by service schedule. Those results showed that: 1) the rates for Residential Service Schedule 1[120] and Extra Large General Service Schedule 25 are below the cost of providing service and the Company proposed a percentage increase to those Schedules above the average, 2) the rates for General Service Schedule 11 and Large General Service 21 are above the cost of providing service and the Company proposed a percentage increase to those Schedules below the average, and 3) the rates for Pumping Service Schedule 31 and Street and Area Lighting Schedules are approximately equal to the cost of providing service and the Company proposed a percentage increase to those Schedules close to average.[121] The Settlement Parties agreed to spread the proposed revenue increase by service schedule in a manner similar to what the Company proposed in its as-filed case.[122]

133 Public Counsel opposes the Settlement Agreement's rate spread and rate design. Public Counsel urges the Commission to reject the Company's cost of service study on the basis that its methodology is not the same as what the Commission has approved in the past for Puget Sound Energy.

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[119] The Settlement-proposed gas rate spread and rate design is similar to that proposed by Public Counsel, and any differences do not result in a material effect. The proposed natural gas increase for a customer using an average of 75 therms per month is 58 cents per month. Exhibit No. 1 at 37.

[120] The proposed increase for a residential customer using an average of 1,000 kwhs per month is $4.73 per month. Including the proposed increase in the ERM surcharge, the increase would be $5.22 per month. Exhibit No. 1 at 32.

[121] Exhibit No. 1 (Joint Testimony) at 31.

[122] Avista Brief at ¶154; *See* Exhibit No. 2 (Settlement Agreement), Attachment C.

134 Public Counsel urges the Commission to adopt the rate spread Mr. Lazar proposed in his testimony. Mr. Lazar's position is that all rate schedules except small and large general service are within a "band of reasonableness" between 90 and 110% of parity. He would spread 75% of the average increase to general service (Schedule 11) and 85% of the average increase to large general service, and the residual on a uniform percentage basis to all other classes. Mr. Lazar justifies his proposal based on the relative class growth in each of the schedules.

135 Avista states that it applies the "peak credit" concept differently than the process approved for Puget Sound Energy because the companies' load profiles are fundamentally different. Avista's cost of service study utilizes Company-specific peak credit assumptions and definition of peak hours, which caused its method to be different than the so-called "Puget Method."[123] In any event, according to Ms. Knox's testimony, the results remain essentially the same whether the "Puget Method" or the Company's method is used.[124] The same customer classes, irrespective of the method used, still demonstrate the same under-recovery or over-recovery of the costs to serve them.[125]

136 Public Counsel also opposes the settlement rate design for electric rates. Public Counsel's approach would allow for no increase in the basic customer, or so-called demand charge, and would load all increased revenue into the higher usage blocks of the various schedules. Public Counsel argues that Mr. Lazar's rate design protects the small residential customers comprising the first block. According to Public Counsel the first block includes high load-factor lights, appliances and gas heat customers, who are facing significant increases in energy

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[123] Avista Brief at ¶155.
[124] Exhibit No. 136 (Knox Rebuttal) at 5:1-12.
[125] Avista Brief at ¶157.

costs due to soaring gas prices. Public Counsel also contends that the first block of residential usage can be met with low-cost hydro.[126]

137 Avista relies on Mr. Hirschkorn's testimony in disputing Public Counsel's contention that there should be no increase in the residential basic charge. Mr. Hirschkorn testified on rebuttal that he would tend to agree with Public Counsel's position if all of the proposed increase in this proceeding represented increased variable costs. However, he states, "a significant portion of the increase . . . represents an increase in fixed costs . . . that do not vary with usage."[127]

138 Avista argues that Public Counsel's proposal that no increase be applied to the first block rate in Residential Schedule 1, and that the entire increase be applied to the second and third blocks, wrongly assumes that the Company's lower cost hydro resources should be used to serve the first 600 kWHs of residential customers' usage each month, and that higher cost thermal resources should be used to serve usage in excess of that amount. As Mr. Hirschkorn testified, this proposal does not reflect the actual operation and dispatch of Avista's generating resources. On Avista's system, hydro generation has a significant amount of flexibility in order to serve variations in load. Accordingly, hydro generation is used to cover both seasonal and intra-day load variations, which would include a substantial amount of energy used to serve the second and third blocks of the Residential Schedule.[128]

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[126]Public Counsel Brief at ¶139.
[127] Exhibit No. 159 (Hirschkorn Rebuttal) at 5:15-21.
[128] *Id*. at 3:14-21, 4:1-7; Avista Brief at ¶158.

Commission Determination

139 The Settlement Agreement strikes a fair balance with respect to rate-spread and the result is well-supported by the record. Avista's cost of service study is tailored to its systems' specific characteristics, as it should be. Movement toward parity measured against that cost of service study is appropriate and the results are fair.

140 The record also supports the Settlement Agreement's rate design. Not all of Avista's increased costs are variable costs. It is reasonable for additional fixed costs to be recovered via a small increase in the basic charge to customers. The pattern of dispatch on Avista's system results in both hydro generation and thermal generation being used to meet the requirements at all levels of service. Accordingly, it is appropriate that the increased revenues be recovered by means of increased rates in the first block, as well as in blocks two and three.

F. Low-Income Programs

141 Under the terms of the Settlement Agreement, Avista will provide an additional $200,000 annually to fund low-income demand-side management, over and above the $900,000 per year presently provided for Demand-Side Management (DSM) funding. Avista also will provide an additional $600,000 per calendar year for two years to the Low-Income Rate Assistance Program (LIRAP), thereby increasing total LIRAP funding to approximately $3 million per year.[129] Each of these commitments continues for two years.

142 The additional DSM funds to low-income will be made available from a reallocation of existing Schedule 91 general DSM funds without an increase in Schedule 91. The additional LIRAP funding will be made available through a

[129] Exhibit No. 1 (Joint Testimony) at 39; Tr. 154:20-155:5 (Mr. Braden).

combination of tax credits and a reallocation of Schedule 191 natural gas DSM funds to LIRAP. There will be no corresponding decrease in natural gas DSM programmatic funding and the Settlement Agreement provides that there will be no increase to Schedule 191 before January 1, 2008.[130]

143 Public Counsel does not oppose the reallocation of funds to low income DSM and LIRAP programs. However, Public Counsel does not view these provisions as justification for approval of the rate increases in the settlement. Energy Project witness Mr. Ebert estimated that approximately 30% of eligible low-income customers are currently served by LIRAP and the analogous Low-Income Home Energy Assistance Program (LIHEAP).[131] In Avista's service territory, according to Public Counsel, "the 70% of customers who are eligible, but won't be served by these programs, would fare best if the Commission ensures that Avista's rate increase in this proceeding is not at an excessive level."[132]

144 Public Counsel opposes the provision of the settlement that would prohibit any increase in the Schedule 191 natural gas DSM tariff rider before January 1, 2008. Public Counsel argues that in an environment of rising natural gas prices, placing a cap on energy efficiency funding is not sensible. Public Counsel contends that adoption of this provision would tie the Company's hands in responding to the growing need for energy efficiency programs.[133]

Commission Determination

145 We commend the Settlement Parties for including provisions in the Settlement Agreement that affirmatively address Avista's low-income programs by increasing funding to support demand-side management and to provide rate

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[130] *Id*. at 29.
[131] Tr. 162:3-6.
[132] Public Counsel Brief at ¶152.
[133] *Id.*

assistance to low-income customers. This is especially important during the current period of rapidly increasing and volatile energy prices.

146 Considering the current volatility and historically high prices in natural gas markets, however, the Settlement Parties' proposal to preclude the possibility of increases in Avista's Schedule 191 Tariff Rider for two years is unreasonable. We find no persuasive argument to support the moratorium proposed in the Settlement Agreement. We condition our approval of the settlement by rejecting this provision.

147 The Settlement Agreement also includes provisions to enhance the programmatic flexibility of the DSM and LIRAP programs so that low-income agencies can more easily implement them. Although these issues were not the subject of much discussion in the parties' briefs, we acknowledge here the success of Avista, Staff, and the Energy Project to improve these programs by allowing the implementing agencies more administrative flexibility.

FINDINGS OF FACT

148 Having discussed above all matters material to our decision, and having stated general findings, the Commission now makes the following summary findings of fact. Those portions of the preceding discussion that include findings pertaining to the Commission's ultimate decisions are incorporated by this reference.

149 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including gas and electric companies.

150 (2) Avista is a "public service company," an "electrical company" and a "gas company" as those terms are defined in RCW 80.04.010 and otherwise used in Title 80 RCW. Avista engages in Washington State in the business of supplying utility services and commodities to the public for compensation.

151 (3) The rates proposed by tariff revisions Avista filed on March 30, 2005, which were suspended by prior Commission order, are not fair, just or reasonable.

152 (4) Avista's existing rates for electric and natural gas service in Washington State are insufficient to yield reasonable compensation for the service rendered.

153 (5) Avista requires relief with respect to the rates it charges for electric and natural gas service in Washington State.

154 (7) The record does not support an immediate change to Avista's Energy Recovery Mechanism (ERM), but demonstrates the need for the Commission to undertake an accelerated and comprehensive review of the mechanism at an early date.

155 (8) Avista's ERM deferral account currently has a positive balance of approximately $100 million, a portion of which the Company is authorized to recover in a monthly surcharge to customers. A 10% increase in the surcharge will promote earlier recovery of the outstanding deferral amount, a result that is in the public interest.

156 (8) The Settlement Parties erred in calculating the value of four factors that underlie the agreed revenue deficiency of $22,135,000, as more fully discussed in the body of this Order.

157 (9) The multi-party Settlement Agreement filed by Avista, Staff, NWIGU, and the Energy Project on August 12, 2005, which is attached to this Order as Appendix A and incorporated by reference as if set forth in full in the body of this Order, considered as a whole, and in its individual parts as discussed and conditioned in the body of this Order, produces end results that are reasonable and in the public interest.

158 (10) Avista's acquisition of the second half of Coyote Springs II combined cycle natural gas turbine generation facility was prudent and the associated costs are reasonable for recovery in rates.

159 (11) The next natural gas general rate case filed by the Avista after resolution of this proceeding will not result in any increase to natural gas base rates prior to July 1, 2007, unless Avista demonstrates extraordinary circumstances.

160 (12) The rates, terms, and conditions of service that result from this Order, based on a revenue deficiency of no more than $22,135,000 for electric service and $968,000 for natural gas service, are fair, just, reasonable, and sufficient.

161 (13) The rates, terms, and conditions of service that result from this Order are neither unduly preferential nor discriminatory.

CONCLUSIONS OF LAW

162 Having discussed above in detail all matters material to our decision, and having stated general findings and conclusions, the Commission now makes the following summary conclusions of law. Those portions of the preceding detailed discussion that state conclusions pertaining to the Commission's ultimate decisions are incorporated by this reference.

163 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to these proceedings. *Title 80 RCW.*

164 (2) The rates proposed by tariff revisions filed by Avista on March 30, 2005, and suspended by prior Commission order, are not just, fair, or reasonable and should be rejected. *RCW 80.28.010.*

165 (3) Avista's existing rates for electric and natural gas service provided in Washington State are insufficient to yield reasonable compensation for the service rendered. *RCW 80.28.010; RCW 80.28.020.*

166 (4) Avista requires relief with respect to the rates it charges for electric and natural gas service provided in Washington State. *RCW 80.01.040; RCW 80.28.060.*

167 (5) The Commission must determine the fair, just, reasonable, and sufficient rates to be observed and in force under Avista's tariffs that govern its rates, terms, and conditions of service for providing electricity and natural gas to customers in Washington State. *RCW 80.28.020.*

168 (6) The multi-party Settlement Agreement filed by Avista, Staff, NWIGU, and the Energy Project on August 12, 2005, which is attached to this Order as

Appendix A and incorporated by reference as if set forth in full in the body of this Order, considered as a whole, and in its individual parts as discussed and conditioned in the body of this Order, represents a reasonable resolution of the issues and is in the public interest. The Commission should approve and adopt the Settlement Agreement subject to the conditions discussed in the body of this Order and set forth in the Ordering paragraphs below. *WAC 480-07-750.*

169 (7) The rates, terms, and conditions of service that result from this Order are fair, just, reasonable, and sufficient. *RCW 80.28.010; RCW 80.28.020.*

170 (8) The rates, terms, and conditions of service that result from this Order are neither unduly preferential nor discriminatory. *RCW 80.28.020.*

171 (9) The Commission's prior order in Docket No. UE-011595 should be amended to the extent necessary to allow for a 10% increase in the current ERM surcharge and to revise the deadline by which Avista must file for a review of the ERM from December 31, 2006, to January 31, 2006. *RCW 80.04.210.*

172 (10) Avista should be authorized and required to make a subsequent filing by January 31, 2006, to initiate a comprehensive inquiry into its Energy Recovery Mechanism. *WAC 480-07-880 and -885.*

173 (11) Avista should be authorized and required to make a compliance filing by December 27, 2006, to implement the terms of this Order, including appropriate tariff sheets that bear an effective date of January 1, 2006. *WAC 480-07-880 and -883.*

174 (12) The Commission Secretary should be authorized to accept by letter, with copies to all parties to this proceeding, a filing that complies with the requirements of this Order. *RCW 80.01.030 ; WAC-480-07-550; WAC 480-07-880 and -883.*

175 (13) The Commission should retain jurisdiction over the subject matter and the parties to this proceeding to effectuate the terms of this Order. *Title 80 RCW.*

ORDER

THE COMMISSION ORDERS THAT:

176 (1) The proposed tariff revisions Avista filed on March 30, 2005, which were suspended by prior Commission order, are rejected.

177 (2) The Settlement Agreement filed by Avista, Staff, NWIGU, and the Energy Project, attached to this Order as Appendix A and incorporated by reference as if set forth in full in the body of this Order, is approved and adopted as a full and final resolution of this general rate proceeding, subject to the clarifications, modifications, and conditions discussed in this Order. The Settlement Agreement is modified and conditioned as follows:

> (1) The required reductions in base rates if Avista fails to meet the Equity Building Mechanism targets stated in ¶8 of the Settlement Agreement are increased from one percent to two percent.
>
> (2) Settlement Agreement ¶13 (A), which would reduce the Energy Recovery Mechanism deadband from $9 million to $3 million, is rejected.

(3) Avista is required to make a filing with the Commission by January 31, 2006, to initiate a separate proceeding in which the Commission will undertake a comprehensive review of the Energy Recovery Mechanism.

(4) Avista must reduce the settlement electric revenue requirement prior to making its compliance filing in this docket by $276,000 to reflect a rate base adjustment of $1,882,000 for Coyote Springs II, as discussed in ¶113 of this Order

(5) Avista must reduce the settlement electric revenue requirement prior to making its compliance filing in this docket by $32,000 to reflect a rate base adjustment of $215,000 for the Pro Forma Transmission Project discussed in ¶117 of this Order.

(6) Avista must reduce the settlement electric revenue requirement prior to making its compliance filing in this docket by $165,000 to correct for an error the Settlement Parties made in calculating the hydro normalization adjustment, as discussed in ¶¶119 and 120 of this Order.

(7) Avista will rerun the AURORA power cost model using the planned outage data for the Colstrip generating plant as discussed in ¶101 of this Order, and using updated bidding factors to comport with its use of updated gas costs as discussed in ¶107 of this Order. Avista must adjust the amount of power costs included in the reduced settlement electric revenue requirement ($21,662,000) in accordance with the outcome of the required AURORA rerun prior to making its compliance filing in this docket, subject to the limitation that any positive adjustment will not result in the compliance filing being based on an electric revenue requirement greater than $22,135,000. Avista is authorized, but not required to file a petition for recovery of any increase

in power costs that would produce a revenue requirement greater than $22,135,000.

(8) Rejection of the two year moratorium on possible increases in Avista's Schedule 191 Tariff Rider, as discussed in ¶146 of this Order.

178 (4) The Commission's Final Order in Docket No. UE-011595 is amended to the extent necessary to allow for a 10% increase in the current Energy Recovery Mechanism surcharge and to revise the deadline by which Avista must file for a review of the Energy Recovery Mechanism from December 31, 2006, to January 31, 2006.

179 (5) Avista is authorized and required to make a subsequent filing by January 31, 2006, to initiate a comprehensive inquiry into its Energy Recovery Mechanism.

180 (6) Avista is authorized and required to file tariff sheets that are necessary and sufficient to effectuate the terms of this Order. The required tariff sheets must be filed by December 27, 2005, to give the Commission an opportunity to review the Company's compliance filing, and shall bear an effective date of January 1, 2006.

181 (7) The Commission Secretary is authorized to accept by letter, with copies to all parties to this proceeding, a compliance filing that implements the requirements of this Order.

182 (8) The Commission retains jurisdiction to effectuate the terms of this Order.

DATED at Olympia, Washington, and effective this 21st day of December, 2005.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARK H. SIDRAN, Chairman

PATRICK J. OSHIE, Commissioner

PHILIP B. JONES, Commissioner

NOTICE TO PARTIES: This is a Final Order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this Order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-07-870.

[Service Date December 21, 2005]

APPENDIX A