**Exhibit No. \_\_\_ T (KLE-7T)**

**Dockets UE-120436, et al.**

**Witness: Kenneth L. Elgin**

**BEFORE THE WASHINGTON STATE**

**UTILITIES AND TRANSPORTATION COMMISSION**

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| **WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,**  **Complainant,** **v.****AVISTA CORPORATION, d/b/a AVISTA UTILITIES,**  **Respondent.****WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,** **Complainant,****v.****AVISTA CORPORATION d/b/a AVISTA UTILITIES,** **Respondent.** | **DOCKETS UE-120436/UG-120437** **(*consolidated)*****DOCKETS UE-110876/UG-110877** ***(consolidated)*** |

**REBUTTAL TESTIMONY OF**

**Kenneth L. Elgin**

**STAFF OF WASHINGTON UTILITIES AND**

**TRANSPORTATION COMMISSION**

***In support of the Multi-Party Settlement Stipulation***

**November 19, 2012**

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**I. INTRODUCTION**

**Q. Please state your name, occupation, and business address.**

A. My name is Kenneth L. Elgin. I am a senior financial analyst for the Washington Utilities & Transportation Commission. I previously filed testimony in this docket and my experience and qualifications are in my Exhibit No. \_\_\_ (KLE-3).

**Q. What is the purpose of your testimony?**

A. The purpose of my testimony is to respond to the testimony offered by Public Counsel opposing the Multiparty Settlement Stipulation (Settlement) in this case. Before I do that, however, I remind the Commission of the key features of this Settlement, from Staff’s viewpoint.

**Q. Please briefly describe the key feature of this Settlement, from Staff’s viewpoint.**

A. The Settlement calls for a two-year rate plan under which Avista must manage its costs to have a reasonable opportunity to earn a fair return. The alternative is simply another rate case filing next year. The Settlement provides a fair result and will provide benefits to ratepayers and Avista over the two-year period, and hopefully beyond.

**Q. How is the rest of your testimony organized?**

A. I respond to the three main reasons why Public Counsel opposes the Settlement. I then address several miscellaneous issues raised by Public Counsel.

**II. RESPONSE TO PUBLIC COUNSEL**

**Q. Please state the main reasons why Public Counsel objects to the Settlement.**

A. The three main reasons why Public Counsel is objecting are: 1) the Settlement assumes Avista will experience significant attrition in 2013 and 2014;[[1]](#footnote-1) 2) the Settlement is a “black box”, which means the Commission will not decide several issues Public Counsel wants to litigate[[2]](#footnote-2); and 3) the Settlement uses a rate of return that is not valid.[[3]](#footnote-3)

**A. ATTRITION**

**Q. Turning to the first reason, in evaluating the reasonableness of the Settlement and the determination of Avista’s revenue deficiency, did Staff consider the effects of attrition?**

A. Yes. Although each Settling Party may consider this issue differently, Staff considered attrition in determining whether the Settlement is reasonable.

**Q. Does the Settlement identify a specific amount for attrition?**

A. No.

**Q. Does that mean Staff simply “assumed” the existence of attrition in this case?**

A. No.Staff’s attrition study shows that Avista will likely experience attrition in 2013. Staff’s attrition allowance is $19.1 and $2.8 million, respectively, for electric and natural gas.[[4]](#footnote-4) Therefore, it was not necessary for Staff to simply “assume” the existence of attrition. Indeed, it would be unreasonable for Staff to ignore the effects of attrition. Notably, Public Counsel did not prepare an attrition analysis, nor did Public Counsel testify no attrition exists.

**Q. What position did Public Counsel take with respect to attrition allowances in its direct case?**

A. Public Counsel’s position was that an attrition allowance is not appropriate unless the Company’s financial integrity is at stake. Public Counsel based this position on language to that effect in a 1981 Commission order for Avista in Cause U-81-15 and U-81-26 (consolidated). Public Counsel was also skeptical about attrition because currently, inflation and cost rates of capital are low.[[5]](#footnote-5)

**Q. Were you aware of the language in that 1981 order regarding attrition and its relationship to a utility’s financial integrity?**

A. Yes. I cited and quoted that language from that order in my direct testimony. I noted that Staff was not applying that “financial integrity” threshold in this case, but instead was using attrition as a tool to analyze the Company’s opportunity to earn a fair return.[[6]](#footnote-6)

**Q. To your knowledge, in any Avista rate case subsequent to that 1981 Avista rate case has the Commission applied a “financial integrity” threshold when using attrition as a tool to provide the utility with an opportunity to earn a fair return?**

A. No. In fact, in two subsequent Avista rate cases (under Avista’s prior name, The Washington Water Power Company), the Commission granted an attrition allowance but did not apply or refer to a financial integrity threshold.[[7]](#footnote-7) In fact, in the 1982 case, Public Counsel advocated no attrition due to the financial plight of customers. The Commission specifically rejected that argument and stated that refusing to acknowledge attrition results in rates that do not meet the statutory test and effectively denies the utility an opportunity to earn a fair return.[[8]](#footnote-8)

**Q. To your knowledge, since 1981, has the Commission ever applied a “financial integrity” threshold to the analysis of attrition for any utility?**

A. No. For example, in three subsequent Pacific Power and Light Company rate cases, the Commission granted an attrition allowance without applying or referring to the “financial integrity” threshold the Commission mentioned in its 1981 Avista decision.[[9]](#footnote-9) In one of those cases (U-84-65), the Commission rejected the notion that an attrition allowance should be used only if rates otherwise would be confiscatory.[[10]](#footnote-10)

**Q. Do the lack of inflation and the presence of lower capital costs mean attrition does not exist?**

A. No. The presence of inflation and changing capital costs impact the degree of attrition present. As I testified, declining capital costs act to dampen the impacts of attrition, but may not fully offset the impacts of added capital expenditures and slow load growth on the attrition Avista will likely experience.

**Q. What do you conclude from all this?**

A. I conclude that the Commission’s policy is that an attrition allowance is a tool for evaluating whether a utility has a reasonable opportunity to earn a fair return where historical test period relationships of revenue, expense and rate base are expected to be different than what will likely prevail in the rate year. Staff conducted a detailed attrition study, and concluded Avista in all likelihood will experience attrition in the 2013 rate year. Staff considered this in determining the reasonableness of the Settlement, and it is legitimate for Staff to do so.

**Q. Public Counsel also states there is no evidence or basis for the rate increase in 2014 contained as part of the Settlement.[[11]](#footnote-11) Is this an accurate statement?**

A. No. In fact, the record evidence is clear that attrition is likely to prevail for the foreseeable future.[[12]](#footnote-12) Avista will continue to experience significant increases in its rate base at a time when there is little, if any, growth in revenue. The effect of these circumstances on Avista today and for the next few years will be attrition. In particular, absent a significant reduction in the amount of its capital budget, growth in load and decrease in operating expense, the most likely scenario for Avista in 2014 will be the results Avista is presenting today: a need for additional rate relief. The record evidence is clear on this fact. The question is the degree of attrition Avista will experience and the Settlement provides a reasonable amount to Avista in 2014.

**Q. What data did Staff consider in determining the need for an additional amount of revenue for Avista in 2014 as part of this settlement package?**

A. There were many different factors Staff considered relevant in evaluating the 2014 rate increases in the Settlement. First are the historical facts surrounding Avista’s costs and rates. Avista has filed for rate increases virtually every year this past decade. My Exhibit No. \_\_\_ (KLE-5) shows these increases. Since Docket UE-011595, the average electric rate increase has been 8.6 percent. For the most recent three-year period, the average rate increase has been 4.9 percent. That exhibit also shows annual increases for natural gas. In the last two cases, natural gas rates have increased 2.9 and 2.4 percent, respectively.

 This pattern of rate increases were all the direct result of the same factors present today: capital expenditures twice the size of depreciation expense, increasing non-fuel operating expenses and disproportionate (low) revenue growth.

 Second, Staff considered the historical financial data of Avista’s utility operations in Washington.[[13]](#footnote-13) While I do not necessarily agree with the calculations and how Avista arrived at these figures, I generally agree with the conclusion that these financial results provide evidence of attrition.

Next, Staff considered Avista’s financial forecasts for 2014. These forecasts show Avista plans additional investments of approximately $250 million, revenues continue to be impacted by slow economic growth, and the Company faces continued upward pressure in its non-fuel operating expenses. Finally, Staff considered its own attrition study in this case, which shows attrition in Avista’s utility operations for 2013.

Considering all these factors, Staff reached the inescapable conclusion is that the two-year rate plan in the Settlement provides Avista a reasonable opportunity to earn a fair return, is well-justified and is in the public interest.

**Q. What other factors did Staff consider in determining it is reasonable to consider additional revenues for 2014?**

1. A key element of the Settlement is that it creates the incentive for Avista to reduce its costs. The two-year window under the Settlement for Avista to accomplish this objective is reasonable. In other words, the Settlement provides Avista a set amount of revenues to accomplish cost reductions as it continues to face other cost pressures, including the pressure from investments needed to replace aging infrastructure. This is a substantial benefit to ratepayers, not only in the short-term, when the Settlement is in effect, but also afterward, when those cost reductions become part of a test period in a future rate case.

**Q. Finally, related to the effect of attrition on Avista and the Settlement’s provision for an increase in 2014, Public Counsel argues that the Settlement does not take into account the reduction in labor costs that might be expected from the employee severance plan Avista recently announced.[[14]](#footnote-14) What is your response?**

A. Public Counsel’s argument is very myopic. In fact, Avista’s action to reduce labor costs is precisely the sort of action Staff wanted and expected from management as a result of the Settlement.

Staff has no desire to “micro-manage” Avista. Staff suggests the Commission likely would not order a utility to impose a severance plan of this sort. The point is that the Settlement provides Avista a significant incentive to manage its costs in order to have a reasonable opportunity to earn a fair return, supplanting the existing incentive, which is for annual rate cases.

**Q. In any event, if there will be labor force reductions from the severance program, how does the Settlement consider the potential related cost savings?**

A. The Settlement provides the opportunity for ratepayers to see the known changes in cost due to early retirements when Avista files its next rate case.

**B. “BLACK BOX”**

**Q. You indicated Public Counsel also opposes the Settlement because it is a “black box”. What is your response to this criticism?**

A. First, I acknowledge the Settlement does not definitively resolve on their merits the accounting issues and other issues Public Counsel apparently prefers to litigate in this docket. However, the Commission has routinely accepted settlements that do not resolve all contested issues on their merits.

 In other words, the Settlement in this case is a common form of “black box” settlement the Commission has approved on numerous occasions, and Public Counsel has signed. However, unlike some such settlements, the Commission has the benefit of Staff’s litigation position, and the other parties’ litigation positions, and therefore can evaluate the “black box” accordingly.

 Public Counsel seems to consider Staff’s litigation position as some sort of foundation for the result Avista should expect to receive in litigation. This is simply wrong.

Finally, it is fair to say that the Settling Parties likely would not agree on a common basis for determining the level of rate relief called for by the Settlement. Yet, we all agree that the end result produced by the Settlement is appropriate and in the public interest.

**Q. Please provide Staff’s perspective on the “black box” element of the Settlement in light of Staff’s revenue requirements analysis.**

A. Staff’s direct case for Avista’s electric operations shows a revenue surplus of $1.3 million, and for its gas operations, Staff’s direct case shows a revenue deficiency of $4.0 million. Staff’s electric revenue requirement figure in particular is significantly lower than the Company’s initial request of some $41 million for its electric and $10 million for natural gas operations.

 As the Commission has undoubtedly already discerned, the two most significant issues in this case are rate of return and attrition. Moreover, rate of return also impacts the attrition-adjusted revenue requirement for both electric and natural gas operations. Consequently, rate of return has a material impact on how Staff determined that an increase in rates is appropriate under the terms of this Settlement.

**Q. What rate of return did Staff use in its evaluation of Avista’s revenue requirements?**

A. For purposes of evaluating the revenue requirements aspects of this Settlement, Staff used the overall rate of return of 7.64 percent, which is contained in the Settlement. This rate of return is based upon a return on equity of 9.8 percent and a capital structure with an equity ratio of 47.0 percent to its direct case. The 9.8 percent return on equity is the same return the Commission deemed reasonable for Puget Sound Energy (PSE) this spring in a contested rate case, Docket UE-111048, et al. The 47 percent equity ratio is lower than the equity ratio the Commission found reasonable for PSE. Using the Company’s updated cost of debt of 5.72 percent yields an overall rate of return of 7.64 percent for Avista.

**Q. Please explain the impact of using a 7.64 percent rate of return in the Settlement to evaluate Avista’s and Staff’s revenue requirement.**

A. Using a 7.64 percent rate of return to the Company’s direct case for its electric operations[[15]](#footnote-15) would produce a revenue deficiency of approximately $29 million for 2013. Staff’s response case at the same 7.64 percent rate of return would produce a revenue deficiency of approximately $7 million.

 Within this range are numerous contested adjustments[[16]](#footnote-16), but the biggest difference between the $29 million figure and the $7 million figure is due to the estimate of rate year attrition. The 3.0 percent increase for 2013[[17]](#footnote-17) contained in the Settlement can be viewed as Staff moving its attrition allowance closer to the Company’s request.

For natural gas, the $5.3 million (or 3.74 percent increase) in 2013 under the Settlement is the same figure one would calculate if the Commission accepted Staff’s case in total, except changing the rate of return to 7.64 percent.

**C. RATE OF RETURN**

**Q. Public Counsel also objects to the rate of return in the Settlement.[[18]](#footnote-18) What is Staff’s response on this issue?**

A. First, Public Counsel did not offer any testimony on what the appropriate rate of return should be. Second, as Public Counsel points out, I provided direct testimony on rate of return, and I testified to a fair return lower that the rate of return stated in the Settlement. However, the rate of return in the Settlement is a compromise, and as I mentioned earlier, it reflects the same return on equity the Commission recently decided was fair for Puget Sound Energy (PSE) last spring. The Commission did not accept my rate of return recommendation in that PSE case. I am comfortable with the Settlement in this regard.

 Third, Public Counsel asserts there is a connection between a fair rate of return and whether the Commission should accept an attrition adjustment.[[19]](#footnote-19) Public Counsel is wrong. A basic principle of ratemaking is that a utility is entitled to a reasonable opportunity to earn a fair return. The Commission’s policy is to provide additional revenue if there is sufficient evidence to support an attrition allowance. To my knowledge, the Commission has never conditioned an attrition allowance on a reduced rate of return.

**D. MISCELLANEOUS ISSUES RAISED BY PUBLIC COUNSEL IN OPPOSITION TO THE SETTLEMENT**

**Q. Public Counsel objects to the Settlement due to the January 1, 2013, effective date of the new rates, arguing that provides significant additional revenue to Avista.[[20]](#footnote-20) Is this a reasonable objection?**

A. No. Public Counsel’s testimony advocates that the Commission’s policy should be to ensure customers only pay higher rates after the full ten-month statutory suspension period. However, regulatory lag is not a customer right. The Commission should retain its discretion to determine when rates should take effect based upon the circumstances present at the time. If the rates are reasonable, there is no reason to delay their effective date.

**Q. Public Counsel also objects to the Settlement because the issue of executive compensation and similar issues are not specifically resolved.[[21]](#footnote-21) Is this criticism valid?**

A. No. I note that Staff’s litigation position on these issues is quite similar to Public Counsel’s. Staff considered these issues under the terms of the Settlement and believes the Settlement fairly resolves these issues for purposes of this case.

**Q. Public Counsel takes issue with the terms of the Settlement because it does not specifically address issues regarding the treatment of administrative and general costs.**[[22]](#footnote-22) **Is this criticism valid?**

A. No. Staff reviewed the actions of Avista to improve its accounting for these costs.[[23]](#footnote-23) No other action is necessary.

**Q. Public Counsel takes issue with the Settlement and its treatment of REC revenues.**[[24]](#footnote-24) **Are Public Counsel’s concerns valid?**

A. No.

**Q. Please explain.**

A. First, Public Counsel says the Settlement does not treat REC revenues as “property.”[[25]](#footnote-25) In fact, the Settlement treatment of RECs does not contest this determination. There is no difference in the value of REC revenues available to customers between the Settlement and Public Counsel’s concern about “property.”

 Second, Public Counsel says the REC provision in the Settlement does not necessarily pass back to ratepayers all available REC revenue annually.[[26]](#footnote-26) However, the Commission has yet to rule that a REC revenue return mechanism must not accumulate REC dollars for longer than one year. The point is a practical one; Staff believes there is a reasonable chance the deferred REC revenues may not be material in amount in a particular year, and it may not make practical sense to return them to ratepayers that particular year.

 Finally, Public Counsel complains that 100 percent of all 2012 REC revenues are not necessarily being returned to ratepayers under the Settlement.[[27]](#footnote-27) However, the place for Public Counsel to make that argument is in the 2012 ERM review, which will take place in 2013. The Commission determined the 2011 REC balances in that context.[[28]](#footnote-28)

REC revenue is currently included as part of the ERM mechanism. The Settlement removes REC revenue from the ERM calculation from the rate effective date forward and retains 100 percent[[29]](#footnote-29) for the benefit of customers. The subtle differences between the Settlement and Public Counsel’s position are: 1) The Settlement treatment does not propose a separate tariff as proposed by Public Counsel; instead, it proposes to use tariff Schedule 93 for the ERM and REC revenue; and 2) The Settlement does not require an automatic annual return but allows for the determination in the annual tariff review which would consider an annual return.

Public Counsel and the Settlement consistently call for Avista to defer all REC revenue above the amount contained in the ERM base rate for ratepayer benefit,[[30]](#footnote-30) which satisfies the Commission’s policy that REC revenues belong to ratepayers.[[31]](#footnote-31)

**III. CONCLUSION**

**Q. Please summarize Staff’s response to Public Counsel’s objection to the Settlement.**

A. None of Public Counsel’s arguments either alone or together are sufficient to support Public Counsel’s recommendation that the Commission reject the Settlement. The Commission should view the Settlement in its entirety. The end result is fair and balanced. It provides stable revenue for Avista’s Washington operations, predictable and stable rates for customers and a sufficient window for Avista management to reduce costs to achieve acceptable financial results.

 The Commission should approve the Settlement.

**Q. Does this conclude your testimony in response to Public Counsel’s opposition to the Settlement?**

A. Yes.

1. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 2:4-6 [↑](#footnote-ref-1)
2. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 3:7 to 9; see also: Coppola, Exhibit No. \_\_\_ (SC-17CT) at 5:6 to 13:12; Daeschel, Exhibit No. \_\_\_ (LD-1CT) at 2:22 to 4:17. [↑](#footnote-ref-2)
3. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 3:1 to 5. [↑](#footnote-ref-3)
4. Breda, Exhibit No. \_\_\_ (KHB-1T) at.2:13-16. [↑](#footnote-ref-4)
5. Dittmer, Exhibit No. \_\_\_ (JRD-10T) at 3:13-21 and at 8:1 to 9:3. [↑](#footnote-ref-5)
6. Elgin, Exhibit No. \_\_\_ (KLE-1T) at 4:17 to 5:15. [↑](#footnote-ref-6)
7. *Utilities and Transp. Comm’n v. The Wash. Water Power Co.,* Cause U-82-10 and U-82-11, Second Supplemental Order (December 30, 1982) at 31; *The Wash. Water Power Co.,* Cause U-83-26, Fifth Supplemental Order (January 19, 1984) at 29-30. [↑](#footnote-ref-7)
8. *Utilities and Transp. Comm’n v. The Wash. Water Power Co.,* Cause U-82-10 and U-82-11, Second Supplemental Order (December 30, 1982) at 31. [↑](#footnote-ref-8)
9. *Utilities and Transp. Comm’n v. Pacific Power & Light Co.,* Cause U-82-12 and U-82-35, Fourth Supplemental Order (February 1, 1983) at 30-31; *Utilities and Transp. Comm’n v. Pacific Power & Light Co.,* Cause U-84-65, Fourth Supplemental Order (August 2, 1985) at 34-37; *Utilities and Transp. Comm’n v. Pacific Power & Light Co.,* Cause U-86-02, Second Supplemental Order (September 19, 1986) at 32-33. [↑](#footnote-ref-9)
10. *Utilities and Transp. Comm’n v. Pacific Power & Light Co.,* Cause U-84-65, Fourth Supplemental Order (August 2, 1985) at 36. [↑](#footnote-ref-10)
11. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 2:3-17; 9:4-13; and 17:6 to 20:14; Daeschel, Exhibit No. \_\_\_ (LD-1CT) at 4:18 to 6:14. [↑](#footnote-ref-11)
12. Exhibit No. \_\_\_ (MTT-1T) at 7:7-11; Avista Response to Staff Data Request 137. [↑](#footnote-ref-12)
13. Morris, Exhibit No. \_\_\_ (SLM-1T) at 14, Illustration 5. [↑](#footnote-ref-13)
14. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 20:15 to 22:2. [↑](#footnote-ref-14)
15. Company’s direct case, as amended through discovery. [↑](#footnote-ref-15)
16. Including many adjustments for items Public Counsel prefers to be fully litigated. [↑](#footnote-ref-16)
17. The Settlement also calls for amortization of deferred power cost credit balances to reduce the increase from three percent to two percent. [↑](#footnote-ref-17)
18. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 22:4 to 25:25. [↑](#footnote-ref-18)
19. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 25:2-3. [↑](#footnote-ref-19)
20. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 5:12 to 6:5; Daeschel, Exhibit No. \_\_\_ (LD-1CT) at 6:15 to 7:5. [↑](#footnote-ref-20)
21. Coppola, Exhibit No. \_\_\_ (SC-17CT). [↑](#footnote-ref-21)
22. Dittmer, Exhibit No. \_\_\_ (JRD-12CT) at 28:6-19 and 29:1-2. [↑](#footnote-ref-22)
23. Keating, Exhibit No. \_\_\_ (EJK-1T) at 17:9-12. [↑](#footnote-ref-23)
24. Daeschel, Exhibit No. \_\_\_ (LD-1CT) at 10:5-11. [↑](#footnote-ref-24)
25. Id. at 10:9-11 and 13:14-17. [↑](#footnote-ref-25)
26. Id.at 10:6 and 10:12-22. [↑](#footnote-ref-26)
27. Id. at 11:7-18. [↑](#footnote-ref-27)
28. Avista Corporation, Docket UE-120432, Order 01 (June 28, 2012). [↑](#footnote-ref-28)
29. The amount of RECs deferred is the amount above what is included in the ERM base rate, consistent with Public Counsel’s proposal. [↑](#footnote-ref-29)
30. Settlement at 5; Joint Direct Testimony in Support of Multi-Party Settlement Stipulation at 30:1-7; and Daeschel, Exhibit No. \_\_\_ (LD-1CT) at 9:12-16. [↑](#footnote-ref-30)
31. *Utilities and Transp. Comm’n v. PacifiCorp*, Docket UE-100749, Order 06 (March 25, 2011) at ¶ 202; and *Utilities and Transp. Comm’n v. PacifiCorp*, Docket UE-100749, Order 10 (August 23, 2012) at ¶¶ 65, 69 and 70. [↑](#footnote-ref-31)