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IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF AVISTA CORPORATION FOR THE AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR ELECTRIC AND NATURAL GAS SERVICE TO ELECTRIC AND NATURAL GAS CUSTOMERS IN THE STATE OF IDAHO.	Case Nos. AVU-E-04-1 AVU-G-04-1

REBUTTAL TESTIMONY OF DENNIS E. PESEAU

ON BEHALF OF POTLATCH CORPORATION

June 21, 2004

ORIGINAL

Q. ARE YOU THE SAME DENNIS PESEAU WHO PREVIOUSLY FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

B. I have five areas of brief rebuttal:

1. Staff witness Hessing should not have accepted the Deal A excess gas costs because his compelling arguments to disallow Deal B gas costs apply to Deal A as well.
2. Staff witnesses overlooked the significant change in cost of service methods proposed by Avista witness Knox.
3. Staff witnesses Schunke's and Hessing's proposal to move various rate schedules only 20% of the way to cost of service will perpetuate the longstanding subsidies between customer classes.
4. Coeur Silver Valley witness Yankel's proposal to directly assign primary costs to Schedule 25 class has merit.
5. Staff's proposal to change the method of computing PCA rates should be rejected or modified.

Deal A and Deal B Financial Transactions

Q. WHAT ARE THE PRIMARY ISSUES YOU ADDRESS IN YOUR REBUTTAL TESTIMONY OF MR. HESSING REGARDING DEAL A AND DEAL B?

A. In a nutshell, I agree wholeheartedly with Mr. Hessing's recommendation to exclude all the excess financial costs of the so-called Deal B. In fact, his approach is quite similar to, and parallels, the rationale I provide for excluding Deal B in my direct testimony. There is no need to elaborate on our similar approaches and our identical conclusions with respect to Deal B, other than to point out that our statements of the amounts in dispute differ, primarily because I used system numbers while Mr. Hessing's figures are for the Idaho jurisdiction and test year only.

My issue with Mr. Hessing's testimony is that the very compelling circumstances and facts that lead Mr. Hessing to appropriately deny Avista recovery of Deal B costs, with one exception, should have also compelled him to recommend disallowance of Deal A costs. My testimony recommends the disallowance of the costs of both Deal A and Deal B.

Q. WHAT IS THE ONE EXCEPTION TO THE SIMILARITY OF CIRCUMSTANCES SURROUNDING BOTH DEAL A AND DEAL B?

A. The one dissimilar circumstance is that Avista Energy was the counterparty to Deal B. In Deal A the apparent counterparties were Mirant and BP. Thus, the Deal A counterparties that profited so greatly were not part of Avista Corporation's corporate structure. But in all other respects both Mr. Hessing's and my observations and criticisms regarding the impropriety and imprudence of Deal A and Deal B are the same for both deals.

Q. IS THE FACT THAT AVISTA CORPORATION ITSELF DID NOT PROFIT FROM DEAL A SUFFICIENT TO JUSTIFY RECOVERY OF THE DEAL'S EXCESS GAS COSTS IN THE PCA?

A. No. Mr. Hessing's other compelling arguments for denying recovery of Deal B costs on the basis of imprudence also hold for Deal A. Both Mr. Hessing's direct testimony and my own explain at length the numerous peculiarities and irregularities of both Deal A and Deal B that lead to the conclusion that each of these deals was imprudent. In fact, the extended period of 3 ½ years for the Deal A swap actually makes the bet the utility made on Deal A prices far more speculative and imprudent than Deal B.

Q. HOW DOES MR. HESSING EXPLAIN HIS PROPOSAL TO DISALLOW DEAL B BUT ACCEPT DEAL A?

A. On pages 15-16 of his direct testimony, Mr. Hessing offers two reasons for not disallowing Deal A. First, as explained above, the counterparties to Deal A were not Avista affiliates. Second, Mr. Hessing opines that Deal A did not put Avista over "the long limit contained in its Risk Policy."

Q. YOU HAVE ALREADY EXPLAINED YOUR POSITION ON DEAL A COUNTERPARTIES NOT BEING AVISTA AFFILIATES. WHAT IS YOUR RESPONSE TO MR. HESSING ALLOWING DEAL A BECAUSE IT WAS STILL UNDER THE "LONG LIMIT?"

A. As I discussed in more detail in my direct testimony, Deal A and Deal B were both <u>financial trades</u>, not physical transactions. In other words, Deal A and Deal B did not purchase any natural gas. On page 5, lines 14-24 of his testimony, Mr. Hessing describes both the physical index-priced gas purchases and the subsequent financial transactions as if they were all parts of Deal A and Deal B. But the proposed Deal A and Deal B cost adjustments are strictly related <u>only</u> to the financial imprudence of these transactions, and not in any way to the procurement of the physical natural gas. Therefore, I find it irrelevant that the physical purchases were, or were not, over some designated volumetric or long limit. Neither of the Deal A and Deal B financial trades was prudent on behalf of the utility's customers for reasons explained in Mr. Hessing's and my testimony. I urge

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other reckless and unprecedented features of both deals that Mr. Hessing and I identify in our direct testimony, compels the conclusion that both should be excluded from rates on the grounds that their costs were imprudently incurred.

Staff Fails to Acknowledge the Importance of Avista's Incorrect 4-Factor Allocator

Q. WHAT IS YOUR RESPONSE TO STAFF'S ADOPTION OF AVISTA'S COST OF SERVICE METHODOLOGY?

A. Both Mr. Hessing and I testify that Avista's cost of service methodology generally follows that ordered in prior Commission orders. However, I point out that there is a significant change in Avista's newly proposed "4-factor" allocator for common costs. While I indicate that a 4-factor allocator is not objectionable on its face, the manner in which Avista witness Knox constructs this allocator is incorrect and unacceptable.

My issue here is with Mr. Hessing's characterization of Avista's study as consistent with that used in its last general rate case "with minor modifications" (Hessing, page 4. lines 1-2). What I want to make clear, and demonstrate quantitatively, is that his characterization of "minor modifications" holds only if the newly proposed 4-factor method of allocating common (overhead) costs is corrected as I propose on pages 33-40 of my direct testimony. As I show below, the corrected 4-factor allocator I developed represents a less extreme departure from the previously adopted allocator. In the case of Potlatch's Lewiston Facility, the prior method and my corrected 4-factor allocator should, and in fact do, produce similar cost allocations, both of which differ significantly from the Avista results.

Q. HOW DO YOU PROPOSE TO DEMONSTRATE THAT THE INCORRECT ALLOCATOR PROPOSED BY AVISTA IS NOT, AS MR. HESSING STATES, A "MINOR MODIFICATION"?

A. Below I list three columns summarizing the rate schedule rates of return from 1) the "40% energy/60% customer" used and adopted in prior proceedings, 2) Avista's newly proposed but incorrect 4-factor allocator and 3) my corrected Avista's 4-actor allocator[1]:

Class	40%/60% Method	Avista 4-Factor	Potlatch 4-Factor
Schedule 1	1.04%	1.97%	1.84%
General Service	9.35%	9.70%	9.52%
Large General Service	9.26%	8.12%	8.16%
Schedule 25	2.07%	1.17%	1.28%
Potlatch Lewiston	5.61%	5.24%	5.60%
Pumping	7.79%	7.24%	7.22%
Lighting	6.52%	4.55%	4.15%
AVERAGE	**4.71%**	**4.71%**	**4.71%**

Q. PLEASE EXPLAIN THIS TABLE.

A. My intent here is to show that Avista's incorrect 4-factor allocator is much more than a "minor modification." As I discussed in my direct testimony, Avista's results are skewed by its inappropriate inclusion of variable fuel and purchase power expenses in the definition of O&M. By including these energy costs in an allocator meant to allocate fixed common costs, Avista improperly shifts costs to higher load factor customers. While the percentage shift is relatively small, the effect in absolute terms is not. Avista's flawed cost of service change increases Potlatch Lewiston's cost of service by approximately $1,000,000 per year. A shift of this magnitude in common costs defies common sense.

[1] The Potlatch-calculated returns differ from those in my direct testimony because, in order to make accurate comparisons, I do not here change the transmission allocator, as I recommend in my direct testimony.

Correcting Avista's mistaken inclusion of fuel and purchased power expenses, as I show in the column headed "Potlatch 4-Factor," produces final allocations that are less prejudicial to high load factor customers and more consistent with prior orders than Avista's approach. My rebuttal Exhibit 213 summarizes the derivation of the Potlatch 4-Factor method. The other columns are developed from Avista Exhibit 16, Schedules 2 and 3.

Q. HOW DO YOU RECOMMEND THAT THE COMMISSION RESOLVE THESE DISPARATE COST OF SERVICE RESULTS?

A. I recommend that the Commission either stick with its previously adopted "40%/60%" method, or adopt the corrected 4-factor method that I propose.

Staff's Proposed 20% Movement to Cost of Service is Inadequate

Q. WHAT IS THE ISSUE WITH RESPECT TO STAFF'S PROPOSAL TO MOVE EACH RATE SCHEDULE 20% TOWARD COST OF SERVICE?

A. Both Staff witnesses Messrs. Hessing and Schunke proposed to limit the movement of each customer class's rates to 20% of the discrepancy with cost of service, with the remaining revenue requirement deficiency being made up by spreading the deficiency on the basis of an equal percentage to each rate class.

My issue here is that the Staff proposal once again blunts any meaningful movement to cost of service, thereby continuing indefinitely the longstanding inter-class rate subsidies. The concurrent PCA reduction makes this an ideal time to finally make some progress toward rate parity.

Q. PLEASE EXPLAIN.

A. Staff justifies its proposal to make minimal progress toward cost of service on the basis of avoiding rate shock. The unfortunate consequence of limiting rate increases of customer classes currently being subsidized is that it generates a corresponding rate shock to rate classes that are already paying well in excess of cost of service (Potlatch's Lewiston Facility). For example, staff proposes an overall average rate increase of 15.8%. As my chart on page 7 of this testimony points out, the residential class's rates currently generate roughly 20% to 40% of the average rate of return, no matter which cost of service method is adopted. Yet staff proposes to limit the increase to the residential class to 18.8%. On the other hand, Potlatch's current rates generate returns well in excess of the system average return, yet Staff's proposal results in a 14.9% rate increase for Potlatch. Stated another way, depending on the cost of service methodology chosen, Potlatch is generating a rate of return that is approximately 3 to 5 times that of the residential class, but the Staff proposes only a 3.9% difference in the percentage rate increase assigned to the two classes. I respectfully submit this result is neither just nor reasonable.

Q. HOW DOES STAFF'S RECOMMENDATION IN THIS CASE SQUARE WITH ITS RECOMMENDATIONS IN THE PAST?

A. As I understand it, in the previous Avista general rate increase Staff proposed three cost of service options—to move rates one-third, one-half, or entirely to respective costs of service. The Commission instead selected 20% as the overall cap on the movement to cost of service.

Q. DID THAT INITIATIVE IN FACT RESULT IN A PARTIAL CORRECTION OF RELATIVE RATE OF RETURN DISPARITY?

A. Unfortunately, no. In fact the inter-class subsidy of the residential class has increased, rather than decreased, since the last Avista rate case. Under these circumstances, the rate shock argument is wearing very thin. There has been no progress toward the elimination of this subsidy for roughly five years, and I suspect Staff's proposal, if adopted, will be revealed to produce little or no progress when the next Avista rate case rolls around. I fully realize this is a tough issue for the Commission, but the indefinite continuation of a subsidy of this magnitude is simply intolerable. It is bad economics and bad policy and, at best, it only postpones the day of reckoning when the residential class will ultimately have to pay its full cost of service, or something very close to it. At that point, the rate shock will be far worse than it would be in this case.

Q. ARE THERE CIRCUMSTANCES IN THE PRESENT CASE THAT WOULD SOFTEN THE RATE IMPACT OF MOVING MORE BOLDLY TOWARD COST OF SERVICE?

A. Yes, the proposed PCA reduction provides an offset to any rate increase the Commission ultimately approves. For example, if the Commission adopts the Staff's proposed 15.8% general rate increase, the net increase for the Idaho jurisdiction after the PCA adjustment is only 2.4%. Under Staff's 20% proposal, the net increase in residential rates would be only 5.1% in this scenario. There is clearly room to make a more meaningful move than this to equal class rates of return without causing rate shock.

Q. WHAT DO YOU RECOMMEND THAT THE COMMISSION ADOPT IN TERMS OF MOVEMENT TOWARD COST OF SERVICE?

A. I recommend that the Commission do two things. First, it should order that customer class rates move 50% toward cost of service in this case. Second, the Commission should express the intent that in subsequent cases, or within 2 years if no general rate case is filed, rates will be moved an additional 50% toward cost of service.

Coeur Silver Valley's Direct Assignment of Primary Distribution Costs

Q. I NOTICE YOU DID NOT DISCUSS SCHEDULE 25, THE OTHER CUSTOMER CLASS THAT APPEARS TO BE HEAVILY SUBSIDIZED, IN THE PRECEEDING SECTION OF YOUR TESTIMONY. WHY IS THAT?

A. After reading Mr. Anthony Yankel's direct testimony on behalf of Coeur Silver Valley, I am convinced that all of the cost of service studies in this case, including my own, significantly overstate Schedule 25's cost of service. Mr. Yankel points out that it is possible and practical to directly identify all those Avista primary facilities necessary to serve all Schedule 25 customers from the Company's accounting records. Since this is possible, Mr. Yankel argues that it is always more accurate to directly assign those facilities' costs to Schedule 25 customers, rather than average these customer-specific costs into all other residential and smaller general service customers and then allocate them on a less accurate basis.

Q. WHAT IS YOUR POSITION WITH RESPECT TO THIS ISSUE?

A. While I have not fully reviewed Mr. Yankel's analysis, I can state that his position that directly assigned costs are more accurate than those derived by a computed allocation is correct.

The reason that directly assigned costs better reflect cost of service is rather straightforward. If I can directly identify those investments made specifically to serve a customer, I can clearly trace both the cause and the costs of those investments to that customer. Mr. Yankel has identified the direct costs of primary distribution facilities used to serve Schedule 25 customers and, as I understand it, proposes to directly assign these identifiable costs to the Schedule 25 class. I certainly agree in principle that this direct assignment is preferable to an indirect cost allocation.

According to Mr. Yankel's calculations, this direct assignment of primary distribution facilities significantly reduces the purported subsidy of Schedule 25 customers. I have not attempted to verify his calculations. But as I have just noted, Mr. Yankel's adjustment is correct in principle, and unless someone can demonstrate that it has been improperly implemented or calculated, his ultimate conclusion—that Schedule 25's cost of service is overstated—is correct as well.

Staff's Proposal to Change Basis for Computing PCA Rates

Q. DOES STAFF PROPOSE TO CHANGE THE BASIS UPON WHICH PCA RATES ARE COMPUTED?

A. Yes, on pages 22-24 of his testimony, Mr. Hessing proposes that the Commission change from the current method of spreading PCA account balances to customer class rates on an "equal percentage" basis to a method of spreading balances on an equal cents per kwh basis.

Q. WHAT IS YOUR POSITION ON THIS ISSUE?

A. I oppose the proposal on both theoretical and practical grounds. First, I have always argued that power supply costs are not 100% energy or kwh-based and should not, therefore, be spread on an energy-only basis. There is both a fixed or capacity component and a seasonally-differentiated cost component to power supply costs that makes spreading balances on a flat, equal kwh basis inaccurate. Recovering power supply adjustments on a per kwh basis is inconsistent with the way we establish base rates, and should be rejected as a matter of principle.

Q. WHAT IS YOUR PRACTICAL OBJECTION TO THE PROPOSAL?

A. In theory, whether PCA changes are recovered through percentage changes or energy rate adjustments should be a matter of indifference to ratepayers. If base rates are properly set, a customer who pays more under an energy only recovery of a surcharge will also receive a proportionately larger benefit from any PCA "rebate." Over the long haul, each customer's total PCA exposure should be the same under either recovery method.

But as a practical matter, high load factor customers such as Potlatch who compete in national or global markets are not really indifferent. Switching to a per kwh recovery method will make these customers' rates much more volatile, because the surcharges and rebates will both be greater than under the current system. In short, their high rates will be higher and their low rates lower under Mr. Hessing's proposal. This is a concern for Potlatch and other industrial customers because it makes business planning and management more difficult. Furthermore, rate increases can cause disruptions and losses that cannot be recovered by corresponding decreases in subsequent years. To cite but one example, a PCA rate increase can potentially shut an industrial customer off from some markets or, in an extreme case, render production uneconomic in all markets. Losses like these are not likely to be adequately compensated by benefits from PCA rebates in good years.

Q. ARE THERE ANY OTHER PRACTICAL PROBLEMS WITH STAFF'S PROPOSAL?

A. Yes. On page 23, line7 to page 24, line 2, Mr. Hessing carefully explains that, due to the fact that there are currently positive balances in the PCA accounts, and these accounts were collected on the present equal percentage basis, it would be very unfair to high load factor customers to now change and attempt to <u>recover</u> these balances on a new, energy only basis. He proposes that any change approved in the PCA methodology not be implemented until the present deferral balances are cleared. I simply want to underscore that this mixing of methods to accumulate and then to recover such balances is potentially highly prejudicial to high load factor customers unless it is implemented when balances are essentially zero.

Q. DO YOU HAVE A SECOND RECOMMENDATION REGARDING THIS ISSUE?

A. Yes. If the Commission decides to make the change Mr. Hessing recommends in the name of consistency, it should take the proposal to its logical conclusion. If the Commission really believes that power supply adjustments are incurred on a "per kwh" basis, the "cents per kwh" recovery should be "seasonalized" on a monthly or quarterly basis in a manner similar to avoided cost rates. Doing so would allow PCA rates, like other cost components, to track the actual changes in power costs as they vary over the year. It is an easy matter to calculate the actual monthly kwh rate that cause the PCA deferral balances to change, and from this information determine the basis for adjusting the PCA rate seasonally. All the benefits of cost-causation and price signal considerations that apply to base customer rates would then apply to PCA rates.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 9th day of July 2004, I caused to be served a true and correct copy of the foregoing document by the method indicated below, and addressed to the following:

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