BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UG 288

In the Matter of AVISTA CORPORATION dba AVISTA UTILITIES, Request for a General Rate Revision.	STAFF'S REPLY BRIEF

1. Introduction

Staff of the Public Utility Commission of Oregon (Staff) files its Reply Brief in response to Avista Corporation's (Avista or Company) Post-Hearing Brief (sometimes referred to as "Avista Brief"). In this Reply Brief, Staff explains why the Commission should accept its recommended adjustments for each of the following remaining nine open disputed issues[1]:

(a) Capital Structure and Return on Equity (ROE)[2];

(b) Information Technology related to Project Compass[3];

(c) Plant Investment;

(d) Wage & Salaries: Bonus Incentives;

(e) Medical Benefits;

(f) Pension Expense;

(g) Post-Retirement Medical Expenses;

(h) 2015 Bonus Depreciation in ADFIT[4]; and

(i) Rate Design.

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[1] Staff incorporates by this reference its earlier-filed Prehearing Brief. As such, Staff's Reply Brief will respond to the arguments presented in Avista's Brief based upon the discussion set forth in Staff's Prehearing Brief, which anticipated many of Avista's assertions and claims, and then present additional discussion as necessary.

[2] Staff slightly modifies its recommended ROE point as explained in Section 2(A)(2)(a) of this Reply Brief.

[3] Staff significantly modifies its recommended adjustment related to Avista's Project Compass as explained in Section 2(C) of this Reply Brief.

[4] Staff reserves right to further address this issue as explained in Section 2(H) of this Reply Brief.

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2. Argument

A. ***Capital Structure and Cost of Common Equity (ROE)***

(1) Capital Structure

Staff discusses this issue in its Prehearing Brief at page 3. Avista discusses the matter at pages 36-38 of its Post-Hearing Brief.

Staff recommends a capital structure of 49.86% equity and 50.14% Long-Term (LT) Debt for the three reasons noted in the testimony of its sponsoring witness Matt Muldoon.[5] *See* Staff/200, Muldoon/2-3; Staff's Prehearing Brief at 3. Avista in turn requests a capital structure allocated equally between LT Debt and equity (i.e. a 50/50% allocation). *See generally* Avista/300, McKenzie/10.

In its Brief, Avista mainly critiques the analysis and recommendation set forth by the Citizens' Utility Board's (CUB) and the Northwest Industrial Gas Users' (NWIGU) witness Gorman. *See* Avista Brief at 37-38. As to Staff, Avista briefly notes that Staff's recommended capital structure is, when rounded, largely consistent with the Company's recommended structure. Avista Brief at 37. While this may be true from a mathematical viewpoint, it is certainly not appropriate to do so from a Rate of Return viewpoint. Rather, percentages of LT Debt and equity are commonly calculated to two digits to the right of the decimal point, as Staff witness Muldoon has done. *See e.g.*, Commission Dockets UE 213, UE 70, UE 111, UE 116, UE 117, UG 246, and UG 132.

(2) Cost of Common Equity (ROE)

Staff discusses ROE at pages 3-6 of its Prehearing Brief. Avista discusses this topic at pages 34-53 of its Post-Hearing Brief.

(a) Correction to Staff's Exhibits/202 and 202

Preliminarily, Staff notes that Avista correctly points out that Staff/202 fails to adjust market prices for South Jersey Industries (SJI) after a stock split and that Staff/203 concerning

[5] Throughout this Reply Brief, Staff will refer to the testimony submitted by its witnesses by either identifying the witness directly by name or simply by the generic term "Staff."

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Staff's multi-stage Discounted Cash Flow (DCF) analysis contains two related errors. *See* Avista Brief at 43. In response, Staff recently submitted its errata for Staff/202, Muldoon/4 and Staff/203, Muldoon/2-4 which corrects these errors. The end-result narrows Staff's recommended range of reasonable ROEs, which moves from (8.76% to 9.45%) to (8.97% to 9.39%). Staff's midpoint recommended ROE for Avista increases from the original 9.11% to 9.18%.

(b) Avista's modeling approach is flawed

Avista's recommended 9.9% ROE is based upon the following three primary methods employed by its hired witness McKenzie: the DCF Model, the ECAPM and the Risk Premium Approach. Avista Brief at 34-35. However, Staff witness Muldoon carefully examined both Avista's choice of models and its use of them and concluded that either the models themselves were unreliable or Avista's use of them was flawed, or both. *See* Staff/200, Muldoon/31-40.

Avista's single-stage DCF Model is useful only as a "rule of thumb." It relies upon the implausible assumption that information about all future returns are contained in just a few values, such as the last dividend and an appropriate very long-term average growth rate. The Commission has historically assigned little or no weight to the use of this particular version of the DCF model. *See* Staff/200, Muldoon/32-33; *see also* Commission Order No. 01-777 at 27 (Docket UE 115); Order No. 01-787 at 24 (UE 116).

In the Company's Reply Testimony, Avista witness McKenzie adds a multi-stage DCF analysis but his methods still inflate depictions of investors' expectations. First, Mr. McKenzie continues to argue that keeping high-end outliers and removing low-end outliers within his modeling results is reasonable because he finds low-end outliers "illogical." *See* Avista/1200, McKenzie/28-29. In contrast, Staff suggests that investors and fund managers would more likely screen carefully for a closer peer group and then be informed by modeling results.

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Next, the Company argues that growth rates for Avista are not bounded by growth of the U.S. economy. *See* Avista/1200, McKenzie/47. The Company's position on this point is not supportable as discussed below in Section 2(A)(2)(f).

Third, Avista argues that investors only focus on near-term economic conditions of five years or less. Avista/1200, McKenzie/22-23. But, this incorrectly implies that investors are not informed by the marked decline in projected long-term growth rates as compared to projections from a year ago as summarized in Staff/203, Muldoon/2. Planning for important events, for example, personal estate planning and institutional pensions, all look far into the future. As such, the Company's criticisms of Mr. Muldoon's analysis (and on NWIGU-CUB witness Gorman) cannot mask that Avista's modeling is flawed on these fundamental points.

As to Avista's Risk Premium Model (RPM), it is simply "not a terribly reliable methodology." Staff/200, Muldoon/34; *see also* Commission Order No. 99-697 at 23 (Docket UG 132); Order No. 01-777 at 33-34 (Docket UE 115). This is so because the RPM does not track well when the United States Federal Reserve (Federal Reserve or Fed) has a policy of keeping interest rates low and when markets are dysfunctional, as has been the case in the very recent past. *Id* at 34-37. Indeed, Staff witness Muldoon used an Ibbotson approach to do a "quick check" of how best to calculate equity risk premiums and found that an investor would demand about an 8.5% ROE to be satisfied to own a stock of average risk at year end 2016. *Id.* at 36-37.

Finally, Mr. Muldoon concluded that Avista's use of ECAPM should be given no weight because no investor or fund management firm uses it. Staff/200, Muldoon/37. As to its cousin, CAPM, the Commission no longer relies upon this model. For example, in its Order No. 01-777 at 35, the Commission rejected the single-stage DCF estimates as well as the CAPM and Risk Premium analyses. Staff similarly recommends that the Commission put little weight on the Company's results from these models in this case. Staff/200, Muldoon/39. However, as a check on Avista's work, Mr. Muldoon conducted his own analysis using the model and produced an

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ROE range of 6.37% to 9.33%, which is much lower than the range produced by Avista under the model. *Id.* In examining the discrepancy between Staff's and Avista's CAPM results, Mr. Muldoon determined that the Company had appeared to ignore the low end of industry practice that uses 10-year treasuries as a risk-free rate and had also relied upon an overly-high market risk premium for one of the components of the CAPM equation. Staff/200, Muldoon/37-39.

Avista's criticism of Mr. Muldoon's application of CAPM is unfounded. *See* Avista Brief at 44-45. CAPM heavily relies upon a risk free rate and market premium as illustrated by Avista's Brief at page 44. But, Staff disagrees that investors who read financial news like that provided in Staff/210 (which discusses disturbing market trends for securities) would rush to project high forward treasury rates and market risk premiums. Rather, such investors would moderate their forward expectations. Tepid forward modeling inputs would be consistent with tepid forward economic expectations.

(c) Staff's multi-stage DCF modeling approach is based in Commission precedent and the results obtained are solidly based

Avista begins its argument on this important topic by broadly asserting that Staff witness Muldoon's analysis should be set aside because it fails to meet regulatory standards. Avista Brief at 39-40. As support, Avista sets forth "Table 1," excerpted from its witness McKenzie's testimony, which the Company states shows the average returns authorized for other gas utilities for the last quarter of 2014 through the third quarter of 2015. Avista Brief at 39. The average ROE for these four quarters is 9.73%. Before continuing, Staff notes that if one were to rely upon the more recent first three quarters of 2015, the average return would be reduced to 9.55%. This suggests that the year-over-year downward trend in gas utility ROEs continues into 2015. It is in no way supportive of the sharp 40 basis point spike in authorized ROE (i.e. from Avista's currently-authorized ROE of 9.5% to its requested ROE of 9.9%) that Avista argues is necessary to allow the company the opportunity to attract investors and to access capital as well as its peers.

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Regardless, of greater interest on this topic is the October, 2015 report prepared by the Regulatory Research Associates (RRA – an affiliate of SNL Financial LC) entitled "Regulatory Focus." *See* Staff/1400, Gardner/1-8. This report states that the average ROE arising out of gas rate cases for 2015 (through September of 2015) was 9.49%. This represents a drop of 29 ROE basis points from rate cases decided in 2014. Stated another way, the RRA report shows a downward trend since 2014 in the ROEs determined from gas rate cases in the first three quarters of 2015. Avista's request, to increase its current ROE from 9.5% to 9.9%, is inconsistent with the current trend in reducing gas utility ROEs.

In any event, Staff stands by the results produced by its use of the multi-stage DCF model. The Commission has frequently approved the use of this model, so Avista's broad criticism of it as "failing to meet regulatory standards" is unfounded and incorrect. *See, e.g.*, Commission Order No. 01-777 at 35. Further, Staff's employment of the model, and the results produced, are solidly-based, reliable and should be adopted by the Commission.

Building upon its broad, general criticism of the multi-stage DCF model, Avista then goes on to assert that Mr. Muldoon's use in the model of a long-term growth estimate over a 30-year horizon is flawed. Avista Brief at 41-42. Avista argues that such a long-term horizon is "misplaced" and that Staff should instead match growth estimates with investors' expectations. *Id.* at 40-41. As mentioned earlier, it is simply not credible that investors refuse to be informed by the sharp downward broad consensus reduction in long-run economic projections of U.S. GDP as compared to projections of a year ago. It is further inconsistent for the Company to use a growth rate representing a perpetuity and then later criticize Staff for looking beyond five years into the future. *Id.*

Avista's critique inexplicably ignores the fact that the Commission has expressly approved of Staff's use of multi-stage DCF model many times in the past. This occurred most recently in Commission Order No. 12-408 (Docket UG 221). Staff/200, Muldoon/17, 31.

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Avista next claims that investors are more interested in short-term company-specific expectations. Avista Brief at 42. Avista cites to Value Line's short-term horizon as more appropriate and useful to investors and that Staff's use of a 30-year long-term growth rate horizon is inconsistent with Value Line's shorter-term method. Avista Brief at 42. However, Avista seems to fail to understand that Staff used Value Line for modeling five years into the future and federal government 20-year projections for modeling growth 20 years into the future. This is perfectly appropriate.

Finally, Avista criticizes Staff's elimination of high estimates from its DCF results. *See* Avista Brief at 43-44. Staff's selection of best peers and then modeling is distinct from the elimination of low-outlier utility results within a peer group. Avista seems to not understand that Staff looked at its three stage modeling results for four peer groups, for three growth rates, with and without a Hamada adjustment as displayed in Staff/203, Muldoon/2, and then ended up selecting Staff's own Hamada-adjusted peer group as the best fit. *See* Staff/200, Muldoon/41.

(d) *Staff's selection method for its proxy group is well-founded and appropriate*

Avista also complains about Staff's selection of a comparable company proxy group for its modeling to assist in estimating an ROE for Avista. Avista Brief at 40-41. As an overall observation, while Staff listed its seven selection criteria in its testimony (*see* Staff/200, Muldoon/20), it did not expressly explain the reasons behind each such criterion. *But see* Staff/200, Muldoon/23-24 (where Staff does explain certain aspects of its reasoning behind its peer selection process). Staff has explained its peer selection method to the Commission many times over the years and the Commission has expressed its preference for this type of analysis. *See, e.g.*, Order No. 12-408 at 3; Order No. 12-437 at 6.

The Company set forth issues with two of Staff's criteria: elimination of a company that had less than 80% of its total assets attributable to regulated operations and exclusion of

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companies which underwent a merger within the past four years. Avista was also not satisfied with Staff's inclusion of water utilities in its peer group. Avista Brief at 40-41.

As its first response, Staff used its 80% total asset criterion because Staff selects highly-regulated peer utilities that investors can expect to have comparable prospects to highly-regulated utilities like Avista.

The Company further asserts that Mr. Muldoon "arbitrarily" excluded any company that had been involved in a merger-related transaction within the past four years. However it is appropriate for Staff to do so because such companies are in a state of transition and, as such, it would not be reasonable to rely upon such company data.

Finally, Staff examined water utilities in its "sensitivity analysis" because they closely track average gas utility performance and as such are a way to provide extra useful information to the Commission. Staff/200, Muldoon/23. Staff's examination of water utilities did not reduce Staff's recommended ROE. Indeed, the Company fails to note that while no regulated energy utility has acquired an investor-owned publicly-traded water utility to date, Value Line's description of the Water Utility Industry notes that most water utilities "deferred doing overhauls of their aging infrastructure…many are now spending to replace old pipelines…to meet standards." *See* Staff209, Muldoon/13. Clearly, a better understanding of publicly-traded water utilities may be useful to the Commission in the future.

(e) Staff's consideration of Avista's frequent rate case filings is entirely appropriate

Avista misunderstands Staff's testimony on this issue. Avista states that Staff witness Muldoon lowered Avista's ROE by 20 basis points because of the Company's history of multiple rate case filings. *See* Avista Brief at 46. This is incorrect.

After completing its modeling, and without affecting its results, Staff "checked the reasonableness" of its modeling results by considering: (a) the impact of downward consensus projections of long-run GDP and then (b) the reduction in the Company's riskiness due to

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Avista's recent history of annual rate case filings. Staff/200, Muldoon/42. Staff estimates that the first factor, as shown in Staff/203, Muldoon/2 under "Check of Reasonableness," could amount to a drop of 31 basis points from Avista's currently-authorized ROE of 9.5%. Staff estimated that the second factor, frequency of rate case filings, could account for another reduction to ROE from between one to 20 basis points. *See* Staff/200, Muldoon/42. This provided a range of ROEs from 9.00 to 9.19 percent, with Staff's recommended ROE value of 9.11 percent (corrected to 9.18 percent by Staff's Errata to Staff/202 and Staff/203) falling solidly within the "range of reasonable" ROEs. *Id.* Staff's "check of reasonableness" test performed upon his recommended ROE is based upon its witness Muldoon's informed judgment and upon the fact that the same approach was taken in a similar case by the Public Service Commission of Maryland (MPSC). *See* Staff/200, Muldoon/40-43.

Avista then argues that its frequent rate case filings should actually be viewed by investors as making the Company appear more, rather than less, risky. Avista Brief at 46. The Company's reasoning is based upon the following quote from a Value Line survey: "due to the effects of regulatory lag, [Avista's] earned return on equity has been unimpressive for many years. So, the Company must file rate cases in order to place its capital spending in the rate base and recover higher operating and maintenance expenses." Avista Brief at 46 (quoting from a Value Line survey).

Frankly, Staff does not understand how the quoted material from Value Line undermines Staff's conclusion that frequent rate case filings tend to reduce the risk faced by a utility. Indeed, the Value Line language seems to *support*, not negate, Staff's analysis. If the concern is "regulatory lag," then the more frequently a utility files a rate case, the shorter the "lag time" it takes to recover capital spending and expenses. Indeed, this is the very same conclusion reached by the MPSC about "regulatory lag." Staff stands by its analysis and conclusion set forth in its testimony.

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(f) Staff's selected observations on the analysis presented by NWIGU-CUB witness Gorman

Avista criticizes the analysis performed by NWIGU-CUB witness Gorman at pages 47 to 50 of its Brief. In response, Staff generally supports the work of Mr. Gorman with the following comments.

NWIGU-CUB witness Gorman filed testimony recommending a range of reasonable ROEs from 8.9% to 9.8%, with a recommended ROE of 9.35%. *See* NWIGU-CUB/100, Gorman/2. Staff reviewed Mr. Gorman's testimony, including Table 6 found on NWIGU-CUB/100, Gorman/50, where Mr. Gorman replaces Avista witness McKenzie's overstated inputs, removes Mr. McKenzie's outboard adjustments and removes some of Mr. McKenzie's unsupportable modeling like his expected earnings analysis. Staff agrees with Mr. Gorman's criticisms of Avista's ROE modeling. However, Staff methods differ from Mr. Gorman's in some significant ways. As an example, Staff screened its own utility peer groups, consistent with historical Staff practice. Staff also weighted its three-stage DCF modeling results most heavily as the Commission has found this approach more credible than others. *See, e.g.*, Order No. 12-408 at 3.

Mr. Gorman succinctly explains why U.S. GDP growth is a reasonable proxy for the Company's maximum sustainable long-term growth rate. *See* NWIGU-CUB/100, Gorman/27 starting at line 7. This is consistent with both current and historical Staff testimony. For an example, see UG 221 Staff Opening Testimony Staff/1300, Storm/62.

The fact that this conclusion is indisputable does not prevent Avista from trying to persuade the Commission otherwise. *See* Avista Brief at 48. However, were Avista correct, the Company would grow faster than the US economy in which it operates until it dwarfs the collective S&P 500. In this regard, Mr. Gorman's testimony is not just convincing, it is factual.

As Mr. Gorman states, utility sales have lagged behind GDP growth for more than a decade and, according to the U.S. Department of Energy, Energy Information Administration

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(EIA), are projected to continue this trend for the next 20 years. *See* NWIGU-CUB/100, Gorman/27. Therefore, Mr. Gorman is correct that his GDP growth rate is a conservative proxy for the highest sustainable long-term growth rate of a utility. Mr. Gorman reinforces his point by sharing that text books for those studying fundamental financial economics cover this basic logic and that the historical record is consistent with this basic understanding. *See* NWIGU-CUB/100, Gorman/28.

Mr. Gorman's Three-Stage DCF Modeling Results for the Company's Gas Proxy Group yielded an average of 8.21 percent as shown on Table 4 on NWIGU-CUB/100, Gorman/32. Staff attributes the difference between its 9.18% ROE arising from its three-stage discounted DCF modeling and Mr. Gorman's similar work to factors illustrated in Staff/203, Muldoon/2. Also, Mr. Muldoon follows Staff peer screening practice in the last decade that selects companies in the same Value Line followed industry with characteristics most like that of Avista in its gas distribution operations in Oregon. In contrast, Avista selects *all the gas utilities followed by Value Line* as its gas peer group. *See* Staff/203, Muldoon/2 "Avista Gas Peers." So when NWIGU-CUB accepts the Company's peers, there is that same downward impact to modeling outcomes.

(g) Staff's Cost of Capital Conclusion

In summary, in recommending a range of reasonable ROEs between 8.97 percent and 9.39 percent with a point ROE of 9.18 percent, Staff relies on best available current data and proven methods preferred by the Commission in the recent past. *See, e.g.*, Commission Order Nos. 01-777 at 27 and 33-34; 01-787 at 24; 12-408.

B. <u>Information Technology related to Project Compass</u>

Staff explained its analysis of this issue in its Prehearing Brief at pages 6-7. Avista argues against Staff's conclusions in its Brief at pages 53-64.

There has been a recent event concerning this issue that impacts Staff's recommended adjustment. On January 6, 2016, the Washington Utilities and Transportation Commission

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(WUTC) issued its Order 05 resolving Avista's rate case filing in Washington. *See WUTC v. Avista Corporation*, Order 05, Dockets UE 150204 and UG 150205 (issued January 6, 2016) ("WUTC Order"). In the WUTC Order, the Washington Commission rejected its staff's recommendation to disallow $12.7 million in capital costs related to the Company's Project Compass and also rejected its staff's recommendation to disallow Company bonuses related to Project Compass. *See* WUTC Order at 57-63.

Staff's similar recommendation in this case was heavily based upon the same matters that concerned the WUTC staff. *See generally* Staff/300. However, in light of the Washington Commission's analysis of the issue (*see* WUTC Order at 62, Paragraph 172), Staff has determined to withdraw its recommendation in this case concerning a partial disallowance of the Project Compass capital investment costs.

As to the bonus issue, Staff had originally recommended that all bonuses related to Project Compass be disallowed. *See* Staff/300, Johnson/4-5. However, again in light of the WUTC Commission's findings and analysis on this issue (*see* WUTC Order at 62-63, Paragraph 173), Staff withdraws its recommendation to disallow 100% of the Project Compass bonuses. Instead, Staff recommends that the Commission disallow 50% of these bonuses per its usual standard. *See generally* Commission Order Nos. 99-033 at 62; 99-697 at 44-45; and 97-171 at 74-76 (relating to the Commission's standard treatment for bonuses).

C. ***Plant Investment***

Staff explained its analysis of this issue in its Prehearing Brief at pages 7-10. Avista discusses the matter in its Brief at pages 10-27.

Staff is not persuaded by the evidence and testimony submitted by Avista in support of its capital additions request of $47.6 million.[6] Staff maintains that its recommended use of a 7.75% growth rate, which would result in a reduction of approximately $30 million from capital

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[6] This is the total capital addition amount requested in this filing. The company requested $45.6 million for 2015, inclusive of Project Compass, and an additional $2 million for customer hookups for the first quarter of 2016.

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additions (not including Staff's prior, now modified, separate adjustment for Project Compass), is justified.

Avista challenges Staff's adjustment on several fronts, notably including the following:

1) Staff's recommendation allowing for 7.75% growth is arbitrary and it does not consider the needs of the system as it relates to safety, reliability and an aging infrastructure. Further, the 7.75% growth rate proposed by Staff , which based on an average of the 2002-2013 time-period, is not representative of the Company's current capital investment plans or needs.

2) All of the projects proposed by the Company for 2015 will be in service by the time rates go into effect in early March, 2016. Moreover, the Company has already transferred approximately \$27.3 million of the proposed \$45.6 million, and is on track to transfer the remainder by the end of 2015.

3) The Company's East Medford project is necessary and Avista will do whatever it takes to put it in service by March 1, 2016.

Staff disagrees with the Company's assertion that a 7.75 percent target for growth in 2015 is arbitrary. To the contrary, it is a generous allowance, as it represents a historical average that is higher than the Company's system-wide average growth. Staff's adjustment takes into account the previously approved Project Compass, as well as growth projects, deteriorated system replacement at a higher level than in previous years, street and highway relocations, and Aldyl-A pipe replacement funded at a level on par with 2014. As further support for his proposed adjustment, Staff witness Moore pointed out the "extraordinary" increase in Avista's proposed increase in capital spending in this case (i.e. 22.6% as compared to an average historical rate of 7.75%). Staff/600, Moore/5-6, 8.

In response, Avista acknowledges that the level of 2015 capital additions is higher than in previous years (*see* Avista Brief at 12), but makes an argument that utility investment is often "lumpy in nature," and thus a larger-than-normal increase in rate base can and does sometimes

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occurs. Avista/1400, Schue/4. The Company then argues that 2015 is one of those "lumpy" years of plant investment, and that capital spending in 2016-2018 is anticipated to "return to a more normal level of between $25 and $32 million a year." Avista/1400, Schue/11.

Staff agrees with the "lumpiness of investments" principle in theory. Indeed, this pattern is evident in Avista's rate base growth during the 2002-2013 timeframe, where growth rates ranged from a low of 1.8 percent in 2004 to a high of 18.9 percent in 2008. *See* Staff/600, Moore/5. But, in looking at historical capital additions back to 2001, Staff finds only a single year – 2007 – in which net plant increased by $29.3 million. Indeed, the average capital additions in the years 2001-2013 is approximately $13.2 million. Staff/606, MOORE Work papers. Given this historical context, it is clear the Commission should reject Avista's requested extraordinary increase in capital spending in this case. There is no "lumpiness" to Avista's capital spending pattern, only a steady and dramatic increase in rate base over the last 10 years. *See* Figure 2 below. Further, Avista's historic average capital spending of $13.2 million shows the Company is incorrect when it states that a level of spending for the 2016 to 2018 timeframe of between $25 million and $32 million is to be considered "normal."

Avista states that the higher level of 2015 capital additions is being driven by mainly by Project Compass, the Aldyl-A pipe replacement, the East Medford Project and the Ladd Canyon project. Avista Brief at 12-14. But, taken together, these projects comprise only $21.2 million, less than half the $45.6 million the Company is requesting in 2015. Moreover, Staff's adjustment takes into account Project Compass, the Aldyl-A pipe replacement program funded at a level on par with previous years, and deteriorated system replacement at a level higher than previous years. However, for reasons discussed later in this Section of its Reply Brief, Staff disagrees with the timing of incorporating the East Medford Reinforcement project into this filing.

Mr. Moore's testimony also shows that the Company's rate base in Oregon has grown significantly since 2006, with the aforementioned dramatic 22% increase in 2015, while

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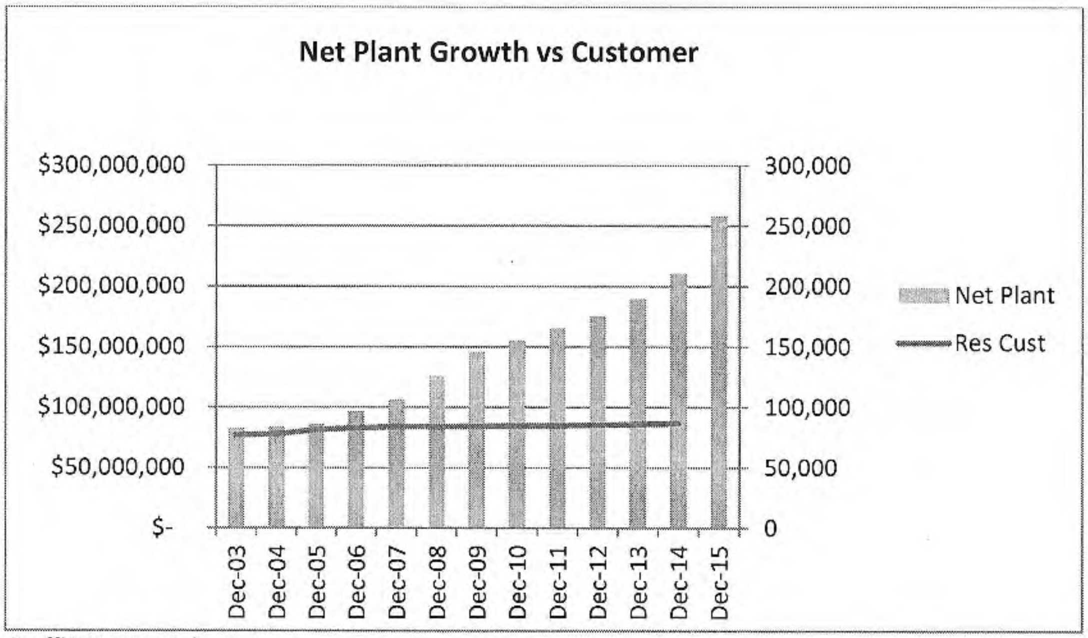
customer growth has remained relatively flat and gas sales have declined. Staff/600, Moore/7, Figures 2 and 3, shown immediately below, illustrate these events.

Figure 2



Staff/600, Moore/7

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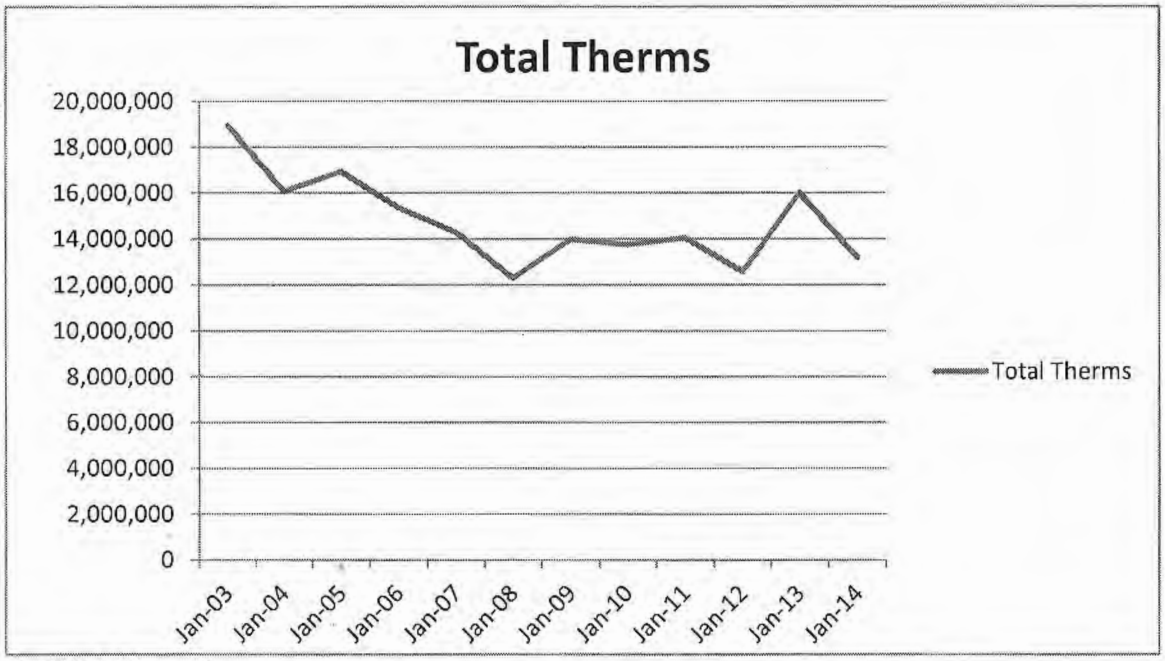
Figure 3



Staff/600, Moore/7

In response, Avista states that Staff "misses the point" in asserting that the level of capital additions in this filing is not supported by the Company's relatively flat growth in terms of number of customers and therm sales. Avista Brief at 14. The Company asserts that it "should invest in plant that provides safe and reliable service to customers, and not be limited by the amount of customer growth that the Company is experiencing…" *Id.*

While Staff agrees that Avista needs to invest in its plant to ensure it provides safe and reliable service, Staff remains very concerned with the Company's dramatic increase in capital investment *in the context of flat customer growth and declining sales in gas volumes*.

Further, the Company has failed to meet its burden to show that its investments are necessary and prudent. *See* ORS 757.210(1)(a). Avista seems to think that it is enough to meet this burden merely by asserting that the overall spending is prudent. But, as Staff points out, it is "up to the Company to identify and prioritize appropriate rate base additions to maintain a healthy plant in order to provide safe, reliable service to its customers at just and reasonable

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rates.… it is the Company's prerogative as to how it chooses to manage its investments to both control costs, [and] provide safe and adequate service." Staff/600, Moore/3. It should not be up to the Commission or Staff to determine what the Company needs in terms of plant investment. Rather, it is up to the Company to determine its needs and make a *compelling* case for why the expenditure is justified in order to recover its costs in this proceeding. The Company has not done so in this filing.

On this point, Staff concludes that the Company's documentation in support of its capital budget is inadequate to demonstrate the necessity and prudence of the extraordinary level of investment that Company requests in this case. Staff/600, Moore/10. The business case summaries provided in support of the projects contain little detail surrounding the specific project activities to be undertaken, and only high-level statements that the projects will be beneficial.

While Staff elaborated on several projects as examples of the inadequacy of the documentation, the Company seems to suggest Staff only takes issue with these few projects. To clarify for the Company, Staff reiterates its conclusion that the overwhelming majority of the capital projects in the filing were not adequately supported. Staff/600, Moore/12. Further, Staff's testimony expresses concern that the overall lack of detail in the majority of the business case summaries may be an indication that the Company is not internally performing a rigorous evaluation of the projects to ensure that they will result in concrete economic benefits to customers. Staff/600, Moore/10.

The Company had an opportunity to supply more evidence to support its spending, but instead it simply re-submitted the business case summaries as exhibits, stating that they were sufficient. The Company instead focused its reply testimony on defending the East Medford and Ladd Canyon projects, which together constitute only $6.2 million of the approximately $46 million capital budget.

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Indeed, Avista actually validates Staffs concerns in its discussion of the approval process used by its Capital Planning Group (CPG). According to Company witness Schue, the various departments within the Company assess the need for capital projects and then develop a business case summary (submitted here in the filing) for each project. The case summary is then presented to the CPG, which meets monthly to review the all business case summaries and prioritize the projects based on the total Company budget. *See generally* Avista/1400, Schule-12-14.

There does not appear to be much scrutiny beyond the department level as to the necessity for the projects. If a department asks for money for a project that sounds reasonable, then, if the money is available, the project is approved. No documentation beyond the high-level business case summaries appears to be provided. The Company then files a rate case each year, requesting to recover the money. The Company's case is predicated on simply asserting that this level of spending is necessary, and implying that it is Staff's burden to prove its imprudence. Essentially, the Company argues in this case that because it has already transferred a good portion of its Capital additions to plant and is on track to transfer the rest, it is therefore entitled to immediately recover those costs from ratepayers. *See* Avista/1400, Schue/4. This is a circular argument and does not supply the necessary justification for incurring those costs.

Staff also observes that the 7.75 percent average growth from 2002-2013, being higher than the 5-6 percent system-wide rate base growth, is an indication that Avista's Oregon ratepayers have historically been shouldering an overlarge portion of system-wide growth. Staff/600, Moore/5.

The Company attempts to counter this point in its reply testimony by including a graph showing 2015 transfers to plant by jurisdiction. Avista/1400, Schue/15; Avista Brief at 15. Transfers to gas net plant in Washington was 16 percent of total system-wide transfers; Oregon and Idaho each comprised 17 percent of the total system-wide transfers to plant. *Id.* Therefore,

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the Company argues, Mr. Moore is incorrect and Oregon customers are not shouldering a disproportionate share of plant additions when compared to other jurisdictions. *Id.*

However, the Company's illustration and argument is misleading for two reasons: a) because it fails to relate that the fact that Avista has 38 percent more customers and sells nearly twice as much gas in Washington as compared to both Oregon and Idaho, (*see* Staff/606 at DR Response 193, Attachment A); and b) this illustration reflects only 2015 transfers to plant, and it does not address the historical imbalance of rate base growth among the jurisdictions. Clearly, Oregon rate payers have been paying for more than their share of total rate base growth. Adding the 11.2 percent growth in 2014 *(see* Staff/600, Moore/4), as well as the plant additions proposed in 2015 to the historical average of 7.75 percent, Oregon's average rate base growth for the years 2002-2015 is 9.06 percent – which is significantly higher than the 5-6 percent average system-wide growth that the Company highlights to investors as an attractive investment opportunity. *See* Staff/600, Moore/5.

In opening testimony, Staff suggests that Avista's higher than average growth rate *may* be reasonable if there had been more customer growth in Oregon than in other jurisdictions, or if there are other unique circumstances in Oregon that require more capital investment than in other states. Staff/600, Moore/5. The Company does not address this matter in its reply testimony, nor in its Prehearing or Post-Hearing Briefs. Staff maintains that the Company has not explained why its current investment needs are so much higher in Oregon than in other jurisdictions, and so much higher than in the past, especially in an environment of flat customer growth and declining gas sales.

Regarding Avista's statement that its increase in capital expenditures has had little impact on customers' bills (*see* Avista/1400, Schue/6; Avista Brief at 17), the impact on customer bills is not the standard by which the Commission evaluates capital spending, and is not related to the question of whether the spending is justified. Staff makes the point in its opening testimony that the Company should invest in its rate base at a measured rate so that rate-payers are not burdened

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with sharp rate increases. Staff/600, Moore/3. The corollary to this statement is also true: rate-payers should not forgo the benefits of lower gas costs and interest rates in order to reward investors with rate base growth that is higher than necessary to provide safe and reliable service.

East Medford Reinforcement Project

In its opening testimony Staff supported the eventual completion of the East Medford Reinforcement Project, but disagreed with the timing of incorporating it into this filing. Staff/600, Moore/14. Upon further discovery, Staff believes this project is not cost beneficial to ratepayers at this point in time.

The project is discussed in detail in Company witness Webb's reply testimony. *See* Avista/1500. The Company asserts that the 3.2 mile installation of 12" high pressure pipe is needed to increase capacity and reliability in the east side of Medford, Oregon. According to the Company, the increased capacity is necessary to meet customer demand on "design day" temperature days, where extreme cold weather places higher-than-normal load on the system. *See generally* Avista/1500, Webb/9-15.

Staff questions the urgency to place the project into service by March, 2016. Staff/600, Moore/14. The East Medford Reinforcement Project was identified in Avista's 2014 Integrated Resource Plan (IRP) as projected to be built in 2018. Avista witness Webb states that the original model supporting the project was based on incorrect data and the model was revised just before the Company's IRP was filed in August, 2014. Avista/1500, Webb/11-13. The revised model reprioritized the $5 million project as "priority one." *See* Avista/1500, Webb/14; Avista/1502. However, Staff notes that during the IRP review process, Avista did not notify the Commission of these changes, nor did it seek to amend its IRP filing to reflect this change.

In addition, the Business Case summary presented in the original filing as documentation to support the acceleration of the project refers only to the need to reinforce the system to supply the gas volumes as identified in the IRP. It does not reflect any evidence of a change in modeling to support moving the project forward into 2015. *See* Avista/1401, Schue/68.

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The Commission has previously commented on the role of transparency during the IRP process in Order No. 12-437 as follows: "The Company not only failed to fully evaluate this project in its IRP, it failed to even tell the Commissioners during the IRP process that it was already actively building the line, instead classifying it as a possible future project in IRP documents. We find this lack of transparency unacceptable." *See* Commission Order 12-437 at 18.

As discussed in Staff's testimony and in Mr. Webb's reply testimony, when cold weather temperatures reach design day conditions – that is, when pressure in the distribution system is at risk of dropping to the point where the ability to serve load is compromised – the Company employs a "Cold Weather Action Plan" (CWAP) to address any deficiencies. Staff/600, Moore/13; Avista/1500, Webb/15-17. As discussed by Mr. Webb, "A (CWAP) includes a decision tree intended to initiate high-level manual intervention activities in particular areas at a pre-defined temperature…These particular activities include: (1) a review of low-pressure areas to ensure identification of areas of concern; (2) identification of customers to notify (either a request to shed load or a notification of possible curtailment of service); and (3) assignment of field personnel to monitor pressures at gas meter sets and regulator stations. The (CWAP) specifies a particular temperature at which local Operations Managers need to assess the general health of the gas system by completing these three actions." *Id.*

Avista's contention is that the CWAP is a back-up plan and should not be relied upon as an ongoing way of serving customers. Mr. Webb asserts that it is "far better to design a system that can be relied upon to serve customers without manual intervention." Avista/1500, Webb/17.

In theory, Staff might agree with this point. However, a determination of prudency of an investment should include an analysis of the cost/benefit to ratepayers. The Company has historically demonstrated its ability to maintain service to customers by employing CWAP in the rare instances where temperatures have approached design day levels. The design heating degree day (HDD) temperature for the Medford area is 61 heating degree days, or 4 degrees Fahrenheit

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average daily temperature. Staff/1400, Gardner/20 (DR Response Staff 330). The last occurrence of an HDD temperature was on December 9, 1972, and it has only experienced one HDD in the last 40 years. Staff/1400, Gardner/21-25 (DR Response Staff 331). In the last 20 years in Medford, the coldest day is a 54 HDD, equivalent to a temperature of 11 degrees Fahrenheit. *Id.* (DR Response Staff 331).

Given the fact that HDD days are rarely reached, that the Company has the ability to employ manual intervention techniques to maintain service to customers, and that historically the Company has successfully been able to maintain service to customers when HDD temperatures are reached, a robust analysis of the cost/benefit to customers should be required to show prudency of this investment.

Moreover, the Company has recently revised its testimony (*see* Avista/1400, Schue/10; Avista/1500, Webb/10) and data request response [Staff/1400, Gardner/53-54 (Supplemental response to Staff DR 342)] to indicate the project will not be complete by the end of 2015, and may not be complete by March 1, 2016 when rates go into effect. *See also* Avista Brief at 19, footnote 65. This means that the project will most likely not be completed until the end of the 2015-2016 heating season. This fact alone supports Staff's contention that the alleged urgent necessity of the project, if it ever existed, no longer applies for this year. Therefore, recovery of this project should not be included in this year's rate filing.

D. <u>Wages & Salaries: Bonus Incentives</u>

Staff discusses this issue in its Prehearing Brief at pages 10-11. Avista discusses the matter in its Brief at pages 6-7.

Essentially, the key question underlying this dispute is whether the Commission considers metrics like "Operation and Maintenance (O&M) cost per customer" to be related solely to ratepayers and not to shareholders. It is Commission policy to not allow full recovery of a bonus if it is based upon a metric (like O&M cost per customer) that is related to a company's earnings, a company's financial results or merit/performance. *See* Staff/800,

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Bahr/20-21; Staff/802, Bahr/35. The Company states that its incentive pay in this case is not based at all on metrics focused on earnings. Staff continues to disagree with the Company on this matter.

Staff stands by its conclusion that O&M cost per customer is a metric related to shareholders as well as to customers. This is supported by Staff/1400, Gardner/11 (Company response to Staff DR 308) which explains the difference between a financial metric and a non-financial metric. Consistent with Staff's position, financial metrics focus on employees achieving goals in a cost effective manner, which encompasses O&M cost per customer.

E. __Medical Benefits__

Staff discusses this issue in its Prehearing Brief at page 11. Avista discusses it in its Brief at pages 7-8. Before commencing, Staff reiterates that it accepts Avista's proposed correction and the amount of Staff's adjustment should be $133,000 (not the $181,000 set forth in Avista's Brief at page 7). *See* Staff Prehearing Brief at 11.

Staff agrees with Avista when it states that medical benefits are only one portion of a compensation package. *See* Avista Brief at 7, lines 15-16. As such, Staff routinely reviews all parts that make up a compensation package, such as wages and salaries, retirement benefits and incentives. Accordingly, Avista's reliance on this point is puzzling.

In any event, Avista's Brief entirely ignores the main underpinnings for Staff's proposed adjustment: (1) use of an 82/18 sharing ratio (i.e. employees pay 18% of premium costs) instead of Avista's 90/10 proposed sharing; and (2) approach used to escalate health care costs to forecast the 2016 costs. *See* Staff/800, Bahr/14-15. Staff stands by its adjustment.

F. __Pension Expense__

Staff discusses this issue in its Prehearing Brief at pages 12-14. Avista discusses the matter in its Brief at pages 27-34. Before commencing, Staff reiterates that it accepts Avista's proposed correction and the amount of Staff's adjustment should be $199,000 (not the $348,000 set forth in Avista's Brief at page 27). *See* Staff Prehearing Brief at 12.

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To begin, Staff's testimony and Prehearing Brief talk in terms of Avista's "derisking" strategy, while Avista's testimony and Brief speak of a concept known as "liability-driven investing" (LDI). *See, e.g.*, Staff Prehearing Brief at 13 and Avista Brief at 28. For simplicity of discussion in its Reply Brief, Staff considers the two terms as being close to synonymous. Moreover, Staff is not generally opposed to a company employing a "derisking" or LDI strategy as Avista suggests (*see* Avista Brief at 30); rather Staff questions Avista's specific investment decisions made under it in this case.

Avista discusses its investment strategy and explains why it chose to move from its 31/69 fixed income to equity ratio (FI/E), to its very conservative ratio of 58/42 FI/E. *See* Avista Brief at 28-32. Staff agrees that such a very conservative strategy should make the Company less subject to market volatility. The concern and problem for Staff is that the stability achieved by Avista's very conservative FI/E ratio comes at the expense of its customers (in the form of foregone higher potential expected and actual returns). Shareholders are the primary beneficiary of reduced volatility and a lower "expected return on assets" (EROA) which increases pension expense to Avista's customers. Staff carefully showed how Avista's current FI/E ratio is extremely conservative as compared to the past returns it has earned on its pension assets and as compared to the EROA achieved by other regulated utilities in Oregon. *See* Staff/800, Bahr/2-9; Confidential Staff/803, Bahr/2-5.

Additionally, the Company states that part of the reason it chose to employ a derisking strategy was because of shorter asset smoothing periods. However, responses from the Company to Staff's Data Requests indicate that the Company is currently *not* electing to take advantage of available accounting provisions that would help to smooth market volatility. *See* Staff/1400, Gardner/17 (Company response to Staff DR 326).

Furthermore, the need for employing a derisking strategy is reduced by other factors as well, such as the decline in funded percentage since employing LDI; precedent of the federal government stepping in to assist companies during recent market crises; the fund still being

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available to certain represented employees of the Company; and the fact that the fund will likely not close for many decades to come. *See* Staff/1400, Gardner/12, 18 and 29 (Company responses to Staff DR Nos. 309, 327 and 335).

For these reasons, Staff stands by its proposed $199,000 reduction adjustment and recommends the Commission adopt it.

G. Post-Retirement Medical Expense

Staff discusses its adjustment on page 14 of its Prehearing Brief. Avista speaks to this issue on pages 8-9 of its Post-Hearing Brief. Staff reiterates that is corrected proposed adjustment is $14,000. *See* Staff Prehearing Brief at 14. Staff has reviewed Avista's Brief and has no additional comments to make to what is stated in its Prehearing Brief.

H. 2015 Bonus Depreciation in ADFIT

Staff discusses this issue on pages 15-16 of its Prehearing Brief. Avista presents its views on page 9 of its Brief.

Preliminarily, Staff notes that the Administrative Law Judge recently issued his Ruling to accept Avista's motion to admit revised testimony (and amend its Brief) on this issue. However, while not objecting to the admission of the Company's revised testimony, Staff issued Data Requests on January 6, 2016 aimed at answering questions raised by the revised testimony. In a conference call with the parties held on January 7, 2016, Avista committed to responding to Staff's Data Requests no later than noon, January 12, 2016. The parties further agreed to convene a second conference call to discuss what further process, if any, will be required at that point. Possible options include the filing of additional Staff and intervenor testimony, or supplemental briefing on this one issue, or both. With that understanding, Staff offers the following observations on this issue based upon the state of the record prior to the filing of Avista's revised testimony.

To begin, Staff reports that on December 18, 2015, President Obama signed into law a new tax act (H.R. 2029) which, among other items, extended the bonus depreciation tax

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deduction for 2015 through 2019. As set forth in the Act, there will be a gradual phase out of bonus depreciation with 50% available for 2015 through 2017, 40% for 2018, and 30% for 2019.

In its response to NWIGU/CUB DR No. 4-5, the Company states: "Based on the information that the Company knows today, it appears that the Company would use bonus depreciation for the 2015 tax year, if bonus depreciation is approved by Congress, which is not known at this time." *See* Staff/1400, Gardner/60. As such, Staff supports the notion of the bonus depreciation adjustment proposed by NWIGU-CUB witness Gorman. *See* NWIGU-CUB/100, Gorman/67.

Based upon the Company's response to NWIGU-CUB DR No. 4-5, combined with the knowledge that bonus depreciation will be available for 2015 and 2016, Staff supports an adjustment to Avista's "accumulated deferred federal income tax (ADFIT) related to bonus depreciation. As Staff notes both in opening testimony and in its Prehearing Brief, the Commission must comply with ORS 757.269. This statute mandates "... amounts for income taxes included in rates are fair, just and reasonable if the rates include current and deferred income taxes and other related tax items that are based on estimated revenues derived from the regulated operation of the utility." Staff/100, Gardner/8-9; Prehearing Brief at 15.

However, Staff does not support NWIGU-CUB's proposal to reduce rate base by $7.5 million for additional AFDIT related to bonus depreciation. *See* NWIGU-CUB/100, Gorman/67. This is because NWIGU-CUB's proposed adjustment is based upon the levels of capital additions set forth in the Company's original filing and Staff has proposed adjustments to these levels in this case. Further, it would not be generally useful for Staff to present new information at this time about a bonus depreciation adjustment based upon Staff's proposed capital account adjustments because the Commission may or may not adopt in whole or in part Staff's proposals. Instead, Staff proposes to submit its recommended amount for an ADFIT adjustment related to bonus depreciation once the Commission issues its Order resolving the outstanding disputed issues in this case.

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I. ***Rate Spread Issue***

Staff discusses this issue at pages 16-18 of its Prehearing Brief. Avista analyzes the matter at pages 65- 76 of its Post-Hearing Brief.

Staff, NWIGU and the Company are generally aligned on the global aspect of this issue: the Commission should allow selected customers to receive a rate reduction while other customers receive a rate increase where there is "compelling evidence" that warrants such disparate treatment. CUB opposes this notion and Avista spends most of its pages explaining why the Commission should not adopt CUB's position.

However, Staff and the Company disagree on the "when and how" selected rate reductions should occur. Staff recommends a nuanced approach that is set forth in detail at Staff/1300, Compton/17-18 and Staff/1303, Compton/4. In brief summary, Staff recommends that if the overall total bill rate increase in this case if four percent or less, the Commission should provide rate decreases to the identified large industrial class. But, to help mitigate possible rate shock, if the overall total bill rate increase is greater than four percent, the affected large industrial class would not receive a rate decrease, but it would also not receive a rate increase.

Avista briefly states that the evidence in the case (i.e. long run incremental cost studies) supports rate reductions to certain schedules and, as such, Staff's proposed nuanced approach should not be adopted. Avista Brief at 73. Staff has nothing further to add to this matter other than to highlight that the impact of Staff's approach to the typical residential customer is only about $1.97 per year, or $0.16 cents per month. *See* Staff/1304.

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3. Conclusion

For the reasons stated, the Commission should adopt Staff's proposed adjustments as set forth in its testimony and as summarized in this Reply Brief.

DATED this 8th day of January, 2016.

Respectfully submitted,

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