[Service Date December 19, 2007]

BEFORE THE WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	)	DOCKET UE-070804 and DOCKET UG-070805 *(consolidated)*
In the Matter of the Petition of AVISTA CORPORATION d/b/a AVISTA UTILITIES, For an Accounting Order Regarding the Appropriate Treatment of the Net Costs Associated with the Repurchase of Debt	)	DOCKET UE-070311 *(consolidated)* ORDER 05 FINAL ORDER REJECTING TARIFF SHEETS; APPROVING AND ADOPTING SETTLEMENT STIPULATION; REQUIRING COMPLIANCE FILING

Synopsis: *The Commission approves and adopts an uncontested Settlement Stipulation that increases Avista Corporation's electric rates by $30,166,000, an average of 9.34 percent across all rate classes, and its natural gas rates by $3,282,000, an average of 1.65 percent across all rate classes. The Commission authorizes increased funding for Avista's low income demand side management and low income rate assistance programs. The approved Settlement terms provide that Avista will charge against earnings $3,850,000 of debt repurchase costs and pay a $15,000 non-compliance penalty to resolve the issues raised by the Company's petition for an accounting order.*

13 The Settlement resolves the capital structure and cost of capital issues at levels close to Staff's litigation position. The key elements are a 10.2 percent rate of return on equity (ROE) and 46 percent equity in the capital structure. While the 10.2 percent ROE is a slight decrease from the currently authorized 10.4 percent ROE, the equity share is increased from the currently approved 40 percent. Given these changes and a reduced cost of debt, the overall rate of return in the Settlement, at 8.20 percent, is 91 basis points lower than the currently authorized 9.11 percent. Much of this reduction is due to a decrease in the cost of total debt in the proposed capital structure.

14 The remaining revenue requirement issues not resolved in the Partial Settlement are resolved in the Full Settlement as follows:

- Customer deposits: Adopts Staff's recommendation to adjust rate base and operating expense resulting in revenue requirement reductions of $171,000 for electric and $100,000 for gas.
- Directors' and Officers' (D&O) Insurance: Reduce revenue requirement by $117,000 for electric and $30,000 for gas.
- Late charges: None will be implemented in this proceeding.

15 The overall results under the Settlement Stipulation, in terms of increased revenue requirement, are $30,166,000 for electric (an average of 9.34 percent across all rate classes) and $3,282,000 for gas (an average of 1.65 percent across all rate classes). This is close to Staff's response case at $29,442,000 for electric (9.15 percent) and $3,172,000 for gas (1.60 percent), and lower than the Company's original requests for $51.1 million (15.85 percent) for electric and $4.5 million (2.27 percent) for gas.

16 The parties agree to a January 1, 2008, effective date for rates filed to recover the additional revenue.

17 The Settlement Stipulation resolves certain remaining significant issues by deferring them for consideration in subsequent proceedings after development of new information. The four issues resolved in this way are rate spread/rate design, demand side management (DSM) expenditures, power cost only rate case (PCORC), and advanced meter reading (AMR).

agree to the following Full Settlement Stipulation in the interest of reaching a fair disposition of this proceeding.

III. AGREEMENT

A. **Cost of Capital** - The following table sets forth the agreed-upon elements of the cost of capital determination in this proceeding:

Agreed-upon Cost of Capital	Percent of Total Capital	Cost	Component
Total Debt	49.30%	6.491%*	3.20%
Trust Preferred Securities	4.70%	6.575%	0.31%
Common Equity	46.00%	10.20%	4.69%
TOTAL	100.00%		8.20%

* The cost of debt incorporates the modifications proposed by Staff in Exhibit KLE-1T.

B. **Remaining Revenue Requirement Issues** –

(1.) **Customer Deposits**: Avista accepts Staff's recommendation to adjust rate base and operating expense for electric and gas operations with respect to customer deposits, resulting in a decrease of $171,000 in revenue requirement for electric and $100,000 in revenue requirement for gas operations

(2.) **Directors' and Officers' (D&O) Insurance**: All Parties have agreed to a reduction in revenue requirement of $117,000 for electric and $30,000 for gas operations, reflecting an adjustment to assign some of the utility portion of premiums paid for D&O insurance to shareholders.

(3.) **Late Charges**: No late charges will be implemented in this proceeding.

Office of the Secretary
Service Date
October 8, 2004

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 NO. AVU-E-04-1 AVU-G-04-1 ORDER NO. 29602

ISSUED OCTOBER 8, 2004

BOISE, IDAHO

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Addressing Potlatch's contention that there is a mismatch between revenues and expenses, Avista witness Falkner contends that each of the Company's test year adjustments fall into an accepted category of adjustment. Revenues, the Company maintains, cannot be annualized to 2004 year-end levels to correct a Potlatch-perceived mismatch because: (1) the 2004 year-end levels of revenues would not be "known and measurable" for another six months, (2) expenses would also need to be adjusted to year-end, and (3) additional revenue from load growth caused by new customers would be offset by additional costs. Tr. at 214-217.

The Commission finds that the timing of the Company's rate case filing was dictated by Company commitment and Commission direction in the Company's 2003 PCA filing, Case No. AVU-E-03-6, Order No. 29377. Avista had a deadline of March 31, 2004 to file its electric general rate case. The timing of the rate case influenced the Company's selection of the test year. The Commission finds use of a 12-month test year ending December 31, 2002 for net operating income and an average of 2004 monthly averages for rate base to be reasonable and appropriate. The matching of test year adjustments will be discussed later with other revenue, expense and rate base adjustments.

CAPITAL STRUCTURE AND RATE OF RETURN

1. Capital Structure

In its initial filing, Avista witness Malquist recommended a pro forma capital structure consisting of 48.19% long-term debt, 5.79% trust preferred securities, 1.72% preferred stock, and 44.30% common equity, that included adjustments to reflect known and projected changes in long-term debt issuances/redemptions and associated costs through September 30, 2004. Tr. at 97-100; 105; 421-426.

Potlatch witness Thornton recommended no changes to Avista's pro forma capital structure. Tr. at 975. Staff witness Carlock, however, contended that the pro forma changes proposed by Avista were not adequately known and measurable. Staff recommended instead using the embedded capital structure at December 31, 2003 consisting of 50.08% debt, 5.57% trust preferred securities, 1.76% preferred stock and 42.59% common equity. Tr. at 1474. Avista in rebuttal agreed with Staff to use the capital structure at the embedded December 31, 2003 actual levels. Tr. at 193.

The Commission finds Avista's actual embedded capital structure at December 31, 2003 as proposed by Staff and agreed to by the Company, to be appropriate for calculating the Company's overall rate of return.

2. Cost of Debt

Avista testified that its embedded cost of long-term debt on December 31, 2003 was 8.68%. Exh. 2, p. 2. The Company proposed making certain pro forma adjustments to update the debt cost through September 30, 2004 to 8.70%. Tr. at 101; Exh. 2, p. 2. Staff accepted and recommended use of the Company's average actual cost of long-term debt outstanding on December 31, 2003, i.e., 8.68%. Tr. at 1475.

The Commission finds it reasonable based on the evidence of the record to reject the pro forma adjustments to be consistent with the capital structure adopted and to use the Company's year-end 2003 embedded cost of debt calculation, 8.68%.

3. Cost of Trust Preferred Securities

Avista testified that its embedded cost of trust preferred securities on December 31, 2003 was 6.15%. Exh. 2, p. 2. The Company proposed making certain pro forma adjustments to update the debt cost through September 30, 2004 to 7.01%. Tr. at 102-103; Exh. 2, p. 2. Staff accepted and recommended use of the Company's embedded cost of trust preferred securities on December 31, 2003, 6.15%. Tr. at 1475.

The Commission finds it reasonable based on the evidence of the record to reject the pro forma adjustments to be consistent with the capital structure adopted and to adopt the Company's 6.15% year-end 2003 embedded cost for trust preferred securities as the appropriate cost rate.

4. Cost of Preferred Stock

Avista witness Malquist testified that the Company's embedded cost of preferred stock on December 31, 2003 was 7.35%. Exh. 2, p. 2. The Company proposed making certain pro forma adjustments to update the preferred stock cost through September 30, 2004 to 7.34%. Tr. at 102-103; Exh. 2, p. 2. Staff witness Carlock accepted and recommended use of the Company's embedded cost of preferred stock on December 31, 2003, 7.35%. Tr. at 1475.

The Commission finds it reasonable based on the evidence of the record to reject the pro forma adjustments to be consistent with the capital structure adopted and to adopt the Company's 7.35% year-end 2003 embedded cost for preferred stock as the appropriate cost rate.

5. Cost of Common Equity Capital

Avista, Staff and Potlatch disagree as to the appropriate cost of common equity capital. The cost of common equity capital, stated as a rate of return on common equity, is a function of several variables. It is primarily an attempt to quantify a rate of return required by investors for that particular investment that is equal to returns earned at the same time by entities of similar risk and uncertainty. The return should also be reasonably sufficient to allow the utility to support its credit and attract new capital needed for utility operations. Avista's electric operation was previously authorized to earn an 8.979% overall return and a 10.75% return on common equity. Case No. WWP-E-98-11, Order No. 28097. For its gas operation the Company was authorized to earn an 11.02% overall return and a 12.75% return on equity. Case No. WWP-G-88-5, Order No. 22749.

Avista in this case requests a rate of return of 11.5% on the common equity portion of its capital structure. Tr. at 98; 104. The Company's cost of capital witness, Dr. Avera, proposes a range for equity return of 10.4-11.9% (eight Western Electric Utilities Benchmark Group) and advocates a higher return within that range. Tr. at 372. Avista witness Malquist believes that the requested 11.5% return will support a bond upgrade and will minimize customer impacts. Tr. at 103-105. Dr. Avera contends that Avista's unique investment risks are significantly greater than the benchmark group. The 11.5% return requested by Avista, Avera contends, is too low given expectations for higher utility bonds going forward, unsettled power markets, below investment-grade credit rating, and hydro uncertainties. Tr. at 372-373.

Staff witness Carlock proposes a range for equity return of 9.5-10.9% and recommends a return on equity of 10.4%. Tr. at 1475. Staff uses the results of discounted cash flow (8.8-11.3%) analysis and the comparable earnings method for industrials and utilities (10-11%) in its computation. Tr. at 1471, 1473.

Potlatch witness Thornton proposes a much lower range for equity return based on a capital asset pricing model (7.70%- 9.90%) and discounted cash flow model analysis (7.5%-9.20%) and recommends a return on equity of 8.5%. Tr. at 1001. Thornton contends that Company witness Malquist bases his return on equity recommendation on personal belief and provides no financial analysis or cost of equity calculations. Tr. at 1003. Thornton believes Company witness Avera's results are upwardly biased and that the eight-company benchmark sampling is too small to impart sufficient confidence. Tr. at 1004-1005. Potlatch witness

Peseau offers simple updates to Avera's data (i.e., growth rate, dividend yields, interest rates) that lowers Avera's ROE estimate by 140 basis points (1.4%). Tr. at 941-952.

Commission Findings

In this case, as in Avista's most recent electric rate case (WWP-E-98-11), the parties have advanced different methodologies to analyze and ascertain a fair rate of return on common equity capital, including discounted cash flow (DCF) method, risk premium analysis, and comparable earnings method. Each method attempts to establish a rate of return on common equity at a point sufficiently attractive that free market investors will consider purchasing common equity shares in the company. As with other analytical tools used in the ratemaking process, the methods to evaluate a common equity rate of return are imperfect predictors of future performance. Additionally, the rate of return on equity specified by a regulatory agency is but one factor considered by prudent investors when evaluating a utility's stock. A utility's stock performance in the marketplace is determined by many variables, including management decisions, weather, streamflow conditions, and a host of separate economic factors. Also considered in the instance of Avista Utilities is the corporate structure of Avista Corporation and the Company's unregulated activities.

This Commission has found it reasonable in the past to primarily rely on DCF and comparable earnings methods to determine an appropriate rate of return on common equity. We have confidence in those approaches and primarily rely on them again in this case. The DCF analysis utilizes the dividend rate, stock price and expected growth rate of a company to quantify the return required by the investor. Flotation costs have also been reflected with the DCF method. The comparable earnings method evaluates returns earned by other companies, including utilities, to quantify an investors expected return, taking into account the risks associated with a particular investment. A third methodology to determine a required rate of return on common equity is the risk premium analysis. The risk premium method starts with the rate of return for a low-risk investment, such as government or utility bonds, and adds a premium based on the relative risk associated with a utility's stock. A fourth method, the capital asset pricing model (CAPM) measures risks using the Beta coefficient. The return on equity is measured in relation to the market as a whole. As markets change, new concerns develop in various financial circles related to the calculations used to determine the cost of equity. One such concern continues to be the measurement and proper use of Beta. This Commission has

not focused on Beta or CAPM for determining the cost of equity; therefore any new concerns or methods are not at issue in this case and will not be specifically addressed.

The Commission has considered all methodologies and rationale in the cost of capital testimony of the witnesses and finds the middle ground position advanced by Staff witness Carlock to be reasonable. The evidence in this case supports a rate of return on common equity for Avista ranging from 9.5-10.9%. This range encompasses the lower end of Avista's recommended range from 10.4-10.9%, and the upper range of 9.5-9.9% from Potlatch's recommendations. We find Avista's reasonable required rate of return on common equity to be 10.4%. This return on equity with the December 31, 2003 capital structure and cost results in an overall rate of return of 9.25%. In authorizing a 10.4% return on common equity, this Commission acknowledges its desire to maintain Avista as a financially viable utility with credit ratings at or above the current level. The Staff proposal, adopted by this Order, results in a pre-tax interest coverage ratio of 2.71 times. Tr. at 453. This is at the bottom of S&P's BBB-rating. *Id.* A rating of BBB would be an increase for Avista. As Avista continues to strengthen its capital structure, refinance high cost debt and address other rating agency concerns, the pre-tax interest coverage ratio will also improve. This is a move in the right direction to improve Avista's utility bond rating. We anticipate that non-utility operations/affiliates will also be making similar efforts to reduce risk and improve earnings contributions to improve ratings. We encourage Avista to investigate with the Staff reasonable ring fencing efforts to further reduce utility risk and improve ratings. The use of this cost of common equity, together with the cost of debt, cost of trust preferred securities, cost of preferred stock and capital structure previously found, yields the following overall return for rate base:

Component	Percentage of Capital Structure	Cost	Weighted Cost
Debt	50.08%	8.68%	4.35%
Trust Preferred Securities	5.57	6.15	.34
Preferred Stock	1.76	7.35	.13
Common Equity	42.59	10.40	4.43
TOTAL	100.00%		9.25%