BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

CASE NO. AVU-E-01-11

DIRECT TESTIMONY OF GARY G. ELY

REPRESENTING AVISTA CORPORATION

Q. Please state your name, business address and present position with Avista Corporation ("Avista").

A. My name is Gary G. Ely and my business address is East 1411 Mission Avenue, Spokane, Washington. I am employed by Avista Corporation as Chairman of the Board, President and CEO.

Q. Please provide an overview of your professional experience at Avista.

A. I joined the Company in 1967. During my thirty-four years with Avista I have held positions in the engineering, operations, marketing and natural gas departments. In 1986 I was named Vice President of Marketing and then received the added responsibility of Gas Supply in 1989. In 1991 I was named Vice President of Natural Gas and was responsible for the Company's overall natural gas systems in Washington, Idaho, Oregon and California. Beginning in 1995, my responsibilities included the overall management of Avista's Hydro Production and Construction, Transmission and Generation Engineering, Rate and Regulatory matters at the state and federal levels, as well as Government Relations. I served as Executive Vice President of Avista Corporation from January 1999 to October 2000.

Q. What is the scope of your testimony in this proceeding?

A. I am testifying as the policy witness for the Company, and, in addition to providing an overview of the filing, will introduce each of the other witnesses proffering testimony on the Company's behalf.

Q. Would you please summarize your testimony?

A. The combination of the worst hydroelectric conditions in 73 years of record together with unprecedented high wholesale market electric prices occurring at the same time has caused the need for prompt rate relief via a 14.7% temporary electric PCA increase in order to enable Avista to obtain financing to support its ongoing operations. For example, the Company has not yet been able to obtain construction financing for the Coyote Springs II project because lenders are concerned about the size of the Company's deferral balances and the absence of rate relief necessary to deal with the deferred cost balances in a timely manner. Unless prompt rate relief is granted, the Company will not be able to complete financings necessary to fund the ongoing operations of the Company. If the needed cash is not forthcoming, the Company will not be able to borrow under its main line of credit, absent consessions from banks. With Commission approval of the requested PCA increase, and recovery of the deferral balances, under current plans the Company would be able to continue to access capital to meet its obligations and complete construction of power resources necessary to meet future customer loads.

Q. Would you please provide a brief summary of the testimony of the other witnesses representing Avista in this proceeding?

A. Yes. In addition to myself, the following witnesses are presenting direct testimony on behalf of Avista.

Mr. Kelly Norwood, Vice President of Energy Resources, will present testimony regarding the unprecedented nature of the current stream flow conditions and power supply markets. Mr. Norwood will explain what costs went into the deferral account and why those expenditures were necessary to insure that the Company met its obligation to meet the retail load demands of our customers. Mr. Norwood explains why the Company's projections indicate that the deferral balance will not decline as previously indicated by the Company, and finally, he explains the credit to the rates of residential and small farm customers related to the BPA Residential Exchange Settlement Agreement which begins in October of this year.

Mr. Jon Eliassen, Senior Vice President and Chief Financial Officer will provide an overview of the cash flow impacts facing Avista. He will also provide an overview of the financing plans and strategies that will be required to meet the near and medium term operational needs of the Company.

Mr. Ron Peterson, Vice President and Treasurer of Avista Corp., will present testimony outlining the cash needs of the Company and will explain the financial covenants that must be met in order to assure continued access to reasonably priced capital to meet the day to day obligations of the Company. He will also explain certain financial benchmarks used by rating agencies to judge the credit worthiness of the securities the Company issues. Mr. Peterson also addresses how the nature and magnitude of the deferral balance is impacting the ability of the Company to raise needed capital.

Mr. Don Falkner, Senior Rate Analyst, discusses the calculation of the overall revenue requirement and the Company's request to use the deferred credit on the Company's balance sheet related to the monetization of the Portland General Electric (PGE) Sale Agreement as an offset to the power cost deferral balance to reduce the overall rate impact to customers.

Mr. Brian Hirschkorn, Senior Rate Analyst, discusses the derivation of the requested PCA increase of 14.7% and outlines how the Company proposes to spread the increase to various rate schedules and usage blocks within rate schedules. Mr. Hirschkorn also will discuss the mitigating impact of the Residential Exchange Settlement on the PCA increase.

Q. Please explain the development of the overall increase.

A. The rates set forth under the proposed PCA Schedule 66 reflect an annual revenue surcharge amount of $23.6 million, or 19.4%, after the Company has already absorbed 10% of the costs under the PCA's 90/10 sharing mechanism. The present Schedule 66 includes a surcharge of $5.7 million, or approximately 4.8%, which is due to expire January 31, 2002. The proposed incremental rate increase to customers is approximately 14.7%. In developing the PCA increase of 14.7% the Company attempted to achieve a balance of mitigating the overall impact to customers, while also reducing the deferral balance to zero as quickly as possible to address the concerns of the financial community. The starting point for the calculation is the actual deferral balance at June 30, 2001. Projected deferral entries beyond June 30, 2001, and through December 2003 are then added to the actual balance.

Projections show that absent a recovery plan, the deferral balance for our Idaho jurisdiction would grow to approximately $70 million by the end of 2001 and be slightly under $90 million by the end of 2003. The derivation of the deferral entries is explained in more detail by Mr. Norwood. The Company is proposing to amortize a deferred credit on the Company's balance sheet related to the monetization of the Portland General Electric (PGE) Sale Agreement as an offset to the power cost deferral balance to reduce the overall rate impact to customers. The Company is then proposing that the remaining balance of the deferred costs be recovered by the end of 2003 through the PCA increase.

Q. Is the amount of the proposed PCA increase in this filing consistent with the parameters of the mechanism approved by the Commission in Order No. 28775?

A. Yes. On page 13 of the Order, the Commission generally established an annual surcharge/rebate limit of $12 million or about 10% of base revenue. However, the Commission goes on to state in the Order: "Rather than a hard and fast rule, the Company, if circumstances arise, may request and seek to justify a different amount." As set forth in the other Company witnesses' testimony, the Company faces an urgent need to implement the proposed PCA increase as soon as possible.

Q. Why is the Company seeking expedited treatment?

A. The Company is proposing a compressed procedural schedule in this case because of its urgent need for rate relief. Prompt relief is necessary to improve cash flow, but more importantly, to begin to deal with the large deferral balances so that the Company can continue to finance expenditures for energy included in the deferral balance and for its construction expenditures and its day-to-day operations.

By year-end, the Company could be precluded from borrowing under its primary commercial bank credit line. Investors and lenders are concerned about the size of the deferral balances and the absence of additional rate relief to deal with the deferred costs. The Coyote Springs II generating resource is the next major resource being built to serve the Company's load obligations. It is imperative that the Company has the ability to obtain financing for projects such as Coyote Springs II, which will be an integral part of the resources needed to serve current and future customer loads.

The Company is planning to sell common stock this fall to provide a portion of the external funds needed. Financial advisors have told the Company that projections showing that Avista may not be able to borrow under its bank credit line will make it very difficult, if not impossible, to sell common stock at a reasonable price and in the time period the Company had planned.

Q. Would you please describe the current energy markets faced by the Company?

A. As Mr. Norwood discusses in more detail, Avista has experienced energy markets that are more expensive and more volatile than at any time in anyone's memory. In addition to the price volatility, we are now in the midst of what is the very worst hydroelectric condition experienced by the Company in the 73 years since records have been kept. I can say without hesitation, that in my 30 plus years with the Company I have never experienced anything quite like this, including the one hundred year ice storm of 1996 and the Washington Public Power Supply System problems experienced by the region in the 1970's and 80's. The Company has never incurred power supply costs of this magnitude and has never had such a small amount of generation available from its hydro system. Available generation from Avista's hydroelectric resources is 194 aMW below normal. At $100 per MWH the replacement cost of that much energy would be $170 million. Market prices in 2001 thus far have averaged well above $100 per MWH.

Of course, we are not alone in this. All of us are all too familiar with the situation in California and the reaction of the banking and financial community as discussed by Mr. Peterson. Other Northwest utilities have also been forced to implement rate increases of as much as 58% and BPA has recently announced a rate increase of 46%.

Q. Wouldn't it be possible for the Company to simply cut costs to address these financial concerns?

A. No. We continue to operate what I believe to be a very efficient utility. The magnitude of the dollars involved in the deferral balance simply overwhelm any savings we might reasonably expect to achieve without totally compromising reliable utility service. For example, Avista's total utility administrative and general expenses for 2000 were $62 million (system). To offset the deferral balance would require cuts that could not be accomplished without crippling our utility operations and our ability to provide even minimal levels of service. Unfortunately, the costs associated with the hydroelectric conditions and wholesale market prices overwhelm the benefits that cost-cutting measures might provide. The Company has, however, implemented budget cuts and other cost saving measures to reduce expenses and improve cash flow.

Q. What specific steps has the Company taken to lessen the impact of the deferral balances and what will the Company do to address the impact of this increase on lower income customers and those customers who otherwise may have difficulty paying their bills during the time this PCA increase is in effect?

A. The Company has taken a number of measures to mitigate the increased power costs such as increased operation of its thermal resources, locking in fixed-price purchases in the prior year, and the installation of small generation resources.

We have also implemented new DSM Tariff funding levels and ramped up our conservation efforts including specific Tariff Rider funding for low-income customers. We have implemented three energy buy back programs to reduce electric load requirements and bring even more customer awareness to the new energy realities faced by the region. And, we will be putting even more emphasis on low-income assistance program in the coming months.

Q. Do you have any concluding remarks?

A. Yes. Avista has made extraordinary efforts to avoid the situation now facing the Company and its customers. Conditions beyond the control of all of us have caused power costs to increase substantially, and it appears that the opportunity to offset the power costs in the future without a retail rate adjustment is no longer possible. Financial exigencies now require the Company to request an exception to the guidelines on the PCA increase amount.

Q. Will the benefits from the BPA Residential Exchange Settlement Agreement offset any of the increase resulting from the requested PCA increase?

A. Yes. The BPA Residential Exchange Settlement Agreement, which begins in October of this year, will provide benefits to the Company's residential and small farm customers. Although the rate reductions related to the Residential Exchange benefits will be handled separately from the proposed PCA rate increase, the timing of the Residential Exchange credit will serve to reduce the overall rate impact to approximately 3% for an average residential customer. The Company plans to file a proposal with the Commission in August to flow the benefits from Residential Exchange Settlement through to its customers. Mr. Norwood and Mr. Hirschkorn provide a more detailed overview of the Residential Exchange Settlement benefits.

Q. Does that conclude your direct testimony?

A. Yes, it does.