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IDAHO PUBLIC
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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION) CASE NO. AVU-E-08-01
OF AVISTA CORPORATION FOR THE) CASE NO. AVU-G-08-01
AUTHORITY TO INCREASE ITS RATES)
AND CHARGES FOR ELECTRIC AND)
NATURAL GAS SERVICE TO ELECTRIC) DIRECT TESTIMONY
AND NATURAL GAS CUSTOMERS IN THE) OF
STATE OF IDAHO) DENNIS P. VERMILLION
)

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

1 I. INTRODUCTION

2 Q. Please state your name, employer and business
3 address.

4 A. My name is Dennis P. Vermillion. I am employed
5 as the Vice President of Energy Resources by Avista
6 Corporation located at 1411 East Mission Avenue, Spokane,
7 Washington.

8 Q. Would you briefly describe your educational and
9 professional background?

10 A. I received a Bachelor of Science degree in
11 electrical engineering from Washington State University in
12 1985. I began working for Avista in 1985 and have held
13 positions in energy trading, marketing, risk management,
14 power transmission contracting, resource planning and
15 coordination and regulatory issues. I was appointed as
16 President and Chief Operating Officer of Avista Energy in
17 2001. I was appointed Vice President of Energy Resources
18 in 2007 at the close of the sale of Avista Energy.

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

21 A. My testimony will provide an overview of Avista's
22 resource planning and power operations which includes
23 summaries of the Company's resources, current and future
24 load and resource position, future resource plans, and a
25 brief discussion of the Company's decision to join the

1 Chicago Climate Exchange. The next section of my testimony
2 discusses hydro and thermal project upgrades. This is
3 followed by the Montana riverbed lease issue, hydro
4 relicensing issues, mercury abatement at Colstrip, and
5 Jackson Prairie storage. My testimony concludes with a
6 discussion of the Company's risk management policy.

7 A table of contents for my testimony is as
8 follows:

	<u>Description</u>	<u>Page</u>
9		
10	I. Introduction	1
11	II. Avista's Resource Planning and Power Operations	2
12	III. Hydro and Thermal Project Upgrades	9
13	IV. Montana Riverbed Lease	14
14	V. Hydro Relicensing	19
15	VI. Mercury Abatement At Colstrip	23
16	VII. Jackson Prairie Storage	24
17	VIII Avista's Risk Management Policy	30

18
19 **Q. Are you sponsoring any exhibits?**

20 A. Yes. I am sponsoring Exhibit No. 4, Schedule 1
21 (Avista's 2007 Electric Integrated Resource Plan), Schedule
22 2 (Memorandum concerning Montana Riverbed Settlement),
23 Schedule 3 (Memorandum of Negotiated Settlement Terms), and
24 Schedule 4 (Avista's Risk Policy).

25

26 **II. AVISTA'S RESOURCE PLANNING AND POWER OPERATIONS**

27 **Q. Would you please provide a brief overview of**
28 **Avista's power generating resources?**

29 A. Yes. Avista's resource portfolio consists of
30 diverse assets including hydroelectric generation projects,

1 base-load coal and natural gas-fired thermal generation
2 facilities, wood waste-fired renewable generation, natural
3 gas-fired peaking generation projects, long-term contracts
4 including wind and Mid-Columbia hydroelectric generation,
5 and market power purchases and exchanges. Avista-owned
6 generation facilities have a total capability of 1,815 MW,
7 which includes 54% hydroelectric and 46% thermal resources.

8 Table No. 1 below summarizes the present capability of
9 Avista's owned generation resources. The Company also has
10 long-term contractual rights for a total of 166 MW of
11 capability from the Mid-Columbia generation projects in
12 2009 that are owned and operated by the Public Utility
13 Districts of Grant, Chelan and Douglas counties. The
14 Company has a ten-year contract for 35 MW of wind
15 generation capability from the Stateline Wind Project. The
16 Company also receives 100 MW of energy from several
17 contracts through 2010.

1

Table No. 1 - Avista Generation

Company-Owned Projects	MW
Noxon Rapids	541
Cabinet Gorge	261
Post Falls	18
Upper Falls	10
Monroe Street	15
Nine Mile	15
Long Lake	90
Little Falls	36
Total Hydroelectric Generation	986
Colstrip Units 3 and 4	230
Coyote Springs 2	287
Kettle Falls	51
Total Base-Load Thermal Generation	568
Northeast CT	62
Kettle Falls CT	7
Boulder Park	25
Rathdrum CT	167
Total Natural Gas Peaking Generation	261
Total Generation	1,815

2

3 **Q. Would you please provide an overview of Avista's**
4 **resource planning and power supply operations?**

5 A. Yes. The Company uses a combination of owned and
6 contracted-for resources to serve its requirements.
7 Dispatch decisions related to these resources are made by
8 the power supply section of the Energy Resources
9 Department. The Department regularly studies capacity and
10 energy resource needs. The Company utilizes short and
11 medium-term wholesale transactions to balance resources
12 with load requirements. Longer-term resource decisions
13 requiring new resources, upgrading existing resources,

1 demand-side management (DSM), and long-term contract
2 purchases are generally made in conjunction with the
3 Company's Integrated Resource Plan (IRP) and Request for
4 Proposals (RFP) processes.

5 **Q. Please summarize the current load and resource**
6 **position for the Company.**

7 A. The Company has added a variety of resources to
8 its portfolio in recent years, including: the second half
9 of Coyote Springs 2; a ten-year agreement for 35 MW of wind
10 generation capability (estimated 7.6 aMW); medium-term
11 purchases of 100 aMW through 2010; the purchase of
12 approximately 7 aMW of small hydroelectric generation from
13 the City of Spokane; hydroelectric upgrades at Cabinet
14 Gorge; approximately 7 aMW of efficiency improvements at
15 Colstrip Units #3 and #4; and a new purchase agreement
16 signed with Grant County PUD for a continued share of the
17 output from the Priest Rapids and Wanapum hydroelectric
18 projects beginning in 2005.

19 The Company is currently in a balanced-to-surplus
20 energy position through 2017 on an average annual basis.
21 This assumes the addition of Lancaster, which is a 245 MW
22 gas-fired plant with an additional 30 MW of duct firing
23 capability; this resource will be described in more detail
24 later in my testimony. However, as I will explain later,
25 there are monthly and quarterly deficits and surpluses

1 prior to 2017. The Company's annual energy net resource
2 position becomes deficient in 2018 and the deficiencies
3 increase from that time forward if additional resources are
4 not added. The average annual energy resource deficiency
5 beginning in 2018 is 8 aMW and increases to 515 aMW in
6 2028.

7 The Company's capacity resource position is surplus
8 through 2018. Capacity deficiencies begin at 67 MW in 2019
9 and increase to 843 MW in 2028. Additional details
10 concerning the load and resource positions are in Company
11 witness Kalich's Exhibit No. 5, Schedule 1.

12 **Q. How does the Company plan to meet future resource**
13 **needs beginning in 2018?**

14 A. The Company has pursued the Preferred Resource
15 Strategy laid out in the 2007 Electric IRP. Avista's 2007
16 Electric IRP is attached as Exhibit No. 4, Schedule 1. The
17 IRP provides details about the need for additional
18 resources, specific cost and operating characteristics of
19 the resources evaluated for the Preferred Resource
20 Strategy, and the scenarios used for resource evaluations.

21 The Company's 2007 Electric IRP was submitted to the
22 Commission in August of 2007. The Company will continue
23 evaluating a mix of resource options to meet future load
24 requirements, including medium-term market purchases,
25 generation ownership, hydroelectric upgrades, renewable

1 resources, customer load reduction (e.g., conservation),
2 long-term contracts, and generation lease or tolling
3 arrangements. As stated earlier, longer-term resource
4 decisions are generally made in conjunction with the
5 Company's IRP and RFP processes, pursuant to Commission
6 rules, although the Company does acquire some resources
7 outside of formal RFP processes. The Company's Preferred
8 Resource Strategy in the 2007 IRP includes a mix of 87 MW
9 of DSM, upgrades to its existing plants, 350 MW of gas-
10 fired CCCT, 300 MW of wind, and 35 MW other renewable
11 generation (such as small co-generation, biomass and
12 geothermal).

13 The Company continues to evaluate and acquire various
14 DSM measures. Avista has acquired approximately 96 aMW of
15 DSM over the past eighteen years. This equates to 5.3% of
16 the Company's owned generation. Avista continues to
17 acquire cost-effective DSM and anticipates acquiring an
18 additional 87 aMW of DSM over the next decade.

19 **Q. Can you please provide an overview of the Chicago**
20 **Climate Exchange and why the Company decided to become a**
21 **member?**

22 A. Yes, the Chicago Climate Exchange (CCX) is the
23 only North American marketplace for integrating voluntary,
24 verifiable and legally-binding emissions reductions with
25 emissions trading and offsets for all six of the greenhouse

1 gases (GHG). The CCX binds members to reducing their GHG
2 emissions by six percent through 2010 based on a baseline
3 level of emissions established by the rules of the CCX.
4 Members must buy credits through the CCX if they are unable
5 to meet their GHG emissions reductions goals up to a
6 maximum amount, or they may sell or bank credits up to a
7 specified amount if they exceed their reduction goals.

8 Avista decided to join the CCX in order to gain
9 experience and develop the internal infrastructure to trade
10 GHG credits. The Company believes this skill will be
11 necessary in anticipation of state or federal legislation
12 regarding GHG emissions in the near future, as discussed in
13 our 2007 Electric IRP. The CCX was also chosen because the
14 Company anticipates that we will have credits to sell in
15 this market. The exact number of credits through 2007 will
16 be known after the baseline audit is completed in the first
17 quarter of 2008. The decision of how or when to dispose of
18 the excess credits has not been made at this time, but will
19 be done after the audit has been completed and the official
20 baseline and reduction goals have been established. The
21 Company plans to pass the net proceeds of the sale of any
22 credits on to customers through the Power Cost Adjustment
23 (PCA) mechanism.

24

25

1 III. HYDRO AND THERMAL PROJECT UPGRADES

2 Q. Please provide an update on the generation
3 upgrades completed on the Cabinet Gorge Projects.

4 A. The Company completed an upgrade of Cabinet Gorge
5 Unit #2 in March 2004. This project consisted of removing
6 the original 1952 propeller runner and replacing it with a
7 current design mixed-flow runner. The upgrade resulted in
8 a 17 MW increase in capacity, from 55 MW to 72 MW, and an
9 increase in energy of approximately 3 aMW. The Company
10 completed a similar upgrade project in 2001 for Cabinet
11 Gorge Unit #3. The capacity of the unit was increased from
12 55 MW to 72 MW which resulted in an estimated 4.5 aMW of
13 additional energy.

14 The Company completed upgrading Cabinet Gorge Unit #4
15 in early April 2007, and obtained an additional 10 MW of
16 capacity and 1.1 aMW of energy from the project at a total
17 investment of \$6.2 million (system). Company witnesses Mr.
18 Kalich and Mr. Johnson have reflected the additional
19 capacity and energy values in their adjustments, and
20 Company witness Ms. Andrews included the investment costs
21 of the upgrade.

22 Q. Can you provide an overview of the repairs that
23 have been completed and the capital improvements that are
24 scheduled to be done on the Noxon Rapids Project?

1 A. Yes. On June 9, 2006, the Unit #4 stator winding
2 failed at the Noxon Rapids Project. This unit was already
3 scheduled to be upgraded in 2007, so the project timeline
4 was accelerated to start in June 2006. The total cost for
5 the core and rewind project was approximately \$7.2 million
6 (system), which included \$4.8 million for the rewind and
7 \$2.4 million for the core. Ms. Andrews has reflected
8 Idaho's share of this investment in her adjustments. The
9 second step to complete the Unit #4 upgrade involves
10 replacement of the turbine runner, which will be done
11 between 2011 and 2012.

12 Currently, work is being done on Unit #5, the largest
13 and most efficient unit at the project, which was installed
14 in 1977. This reliability work began in September 2007 and
15 is expected to be completed by April 2008. The work is not
16 expected to increase the units 92.0% efficiency rating or
17 the 125 MW unit rating, but is expected to solve several
18 reliability concerns. The reliability concerns for Unit #5
19 include stator frame distortion, varying air gap, numerous
20 forced outages, and the need to have a one-hour pre-warming
21 of thrust bearings prior to the unit being started. The
22 costs associated with this work is approximately \$1.6
23 million (system) and has been included in this case as
24 further described in Company witness Mr. DeFelice's

1 testimony and Company witness Ms. Andrews includes the
2 Idaho share of these costs in her adjustments.

3 **Q. Please explain the capital improvements that have**
4 **been done on Colstrip Units 3 and 4?**

5 A. Capital improvements on Colstrip Units 3 and 4
6 began in 2006 to improve operating efficiency, enhance
7 reliability, and to increase generation. Work began on
8 Colstrip Unit #4 on May 8, 2006 with the installation of a
9 new high-pressure steam turbine rotor, which resulted in
10 approximately 28 MW (4.2 MW Company share) in additional
11 capacity using the same amount of fuel. The original
12 analog plant controls were also replaced with digital
13 controls to optimize plant operation. The unit was brought
14 back on line on June 25, 2006. Avista's share of the total
15 investment cost for the Unit #4 upgrade was approximately
16 \$3.0 million (system).

17 On Colstrip Unit #3, the analog to digital control
18 conversion was completed in 2006 and additional capital
19 improvements were completed in May and June of 2007 at a
20 total investment for Avista of \$3.8 million (system).
21 These improvements included the installation of a new high-
22 pressure steam turbine rotor to improve output and
23 efficiency and the installation of NO_x controls on the
24 boiler. These changes are added approximately 28 MW (4.2
25 MW Company share) in additional capacity. Company

1 witnesses Mr. Kalich and Mr. Johnson have included the
2 additional benefits and operating costs from the upgrades
3 in their adjustments, and Company witness Ms. Andrews has
4 reflected the investment costs in her testimony.

5 **Q. Could you summarize the costs and timing of the**
6 **hydro and thermal upgrades included in this case?**

7 A. Yes. Table No. 2, Generation Project Costs,
8 lists the in-service dates, system investment costs, and
9 the Idaho allocation for each project. Ms. Andrews
10 explains the Idaho allocation of rate base and revenue
11 requirements associated with these upgrades.

12

13

Table No. 2 - Generation Project Costs

Generation Projects ⁽¹⁾	Cost: System / ID (000s)	In-Service Date
Cabinet Gorge Unit 4	\$6,200 / \$2,119	Mar-07
Noxon Rapids Unit 4	\$7,189 / \$2,456	Sep-07
Colstrip Unit 4	\$2,949 / \$1,008	Jun-06
Colstrip Unit 3	\$3,760 / \$1,285	Jun-07
Total	\$20,098 / \$6,868	
⁽¹⁾ The additional generation from the Cabinet Gorge Unit 4 and Colstrip Units 3 & 4 project upgrades has been included in the AURORA model as discussed by Company witness Mr. Kalich.		

14

15 **Q. Please describe the additional upgrade projects**
16 **planned for the Noxon Rapids generating units starting in**
17 **2009.**

18 A. The Company plans to upgrade the Noxon Rapids
19 generating units 1 through 4 (currently using 1950's

1 technology). The upgrades on these four units are expected
2 to add an additional 30 MW of capacity and 6 aMW of energy
3 to the Noxon Rapids project and improve reliability on
4 these units. One upgrade is planned for completion
5 annually, starting in March 2009 with completion of each of
6 the upgrades by 2012. Table No. 3, Noxon Rapids Upgrades,
7 summarizes these upgrades:

8
9

Table No. 3 - Noxon Rapids Upgrades

Noxon Rapids Unit #	Schedule of Completion	Additional Capacity	Additional Efficiency
1	Mar. 2009	7.5 MW	5.0%
2	Feb. 2010	7.5 MW	6.0%
3	Feb. 2011	7.5 MW	7.8%
4	Feb. 2012	7.5 MW	4.7%

10

11 For Unit #1, we plan to replace the stator core,
12 rewind the stator, install a new turbine and have a
13 complete mechanical overhaul completed from July 2008
14 through March 2009. This upgrade is expected to increase
15 the unit's efficiency from 87.5% to 92.5% and the unit
16 rating from 105 MW to 112.5 MW. The upgrade will also
17 solve several reliability concerns for the unit including
18 mechanical vibration, the age of the stator, and increase
19 in partial discharge activity and the low efficiency of the
20 unit.

1 Clark Fork River Project located in the State of Montana.
2 This includes the entire Noxon Rapids Project and the
3 portion of the Cabinet Gorge Project within Montana
4 borders, which includes most of the reservoir. The
5 litigation began in October 2003 when residents of Bozeman,
6 Montana, with children in the Montana public school system,
7 filed a lawsuit against the owners of all privately-owned
8 hydroelectric project owners in the state, including
9 Avista, PPL Montana, LLC and PacifiCorp, seeking payment
10 for the use and occupancy of School Trust Lands. This
11 lawsuit was joined by the school districts from Great
12 Falls, Montana and the State of Montana in March of 2004.
13 Although the matter was dismissed by the Federal District
14 Court on jurisdictional grounds, a subsequent declaratory
15 judgment was brought in the state court in November of
16 2004, in order to resolve the issue.

17 This action in state court involved extensive
18 discovery and motion practice around a number of key issues
19 surrounding navigability of the Clark Fork River and the
20 proper measure of damages for any prior trespass since
21 construction of the Noxon Rapids and Cabinet Gorge Projects
22 in the early 1950's. Future ongoing damages were also
23 sought. At time of trial, the State of Montana was
24 prepared to assert damage claims that exceeded \$200 million
25 for prior damages and \$8.4 million per year for future

1 trespass. Exhibit No. 4, Schedule 3 is an overview of the
2 litigation that describes the nature of the claims and the
3 basis for the ultimate settlement.

4 PacifiCorp was dismissed from the lawsuit in June 2006
5 after entering a voluntary settlement with the State of
6 Montana. Avista was also dismissed from the lawsuit in
7 October 2007 after entering into a voluntary settlement
8 with the State. PPL Montana, LLC was the only
9 hydroelectric owner in the lawsuit that elected to proceed
10 to trial. The outcome of the lawsuit has not been decided
11 at this time.

12 **Q. What issues were decided by the court in advance**
13 **of trial?**

14 A. In September and October of 2007 the Montana
15 District Court made several determinations as a matter of
16 law in advance of trial: The Clark Fork River was deemed
17 "navigable" for the express purposes of the establishment
18 of the State's claim to title of the riverbed. The State
19 owns the Clark Fork riverbeds and may therefore charge the
20 hydroelectric owners for the use of the beds. The riverbed
21 lands are School Trust Lands. There are no statutes of
22 limitation or equitable defenses which would limit claims
23 back to the time when the hydroelectric projects were
24 constructed. Because the riverbeds were deemed to be
25 School Trust Lands, there was an obligation to pay rents

1 under the Montana Hydroelectric Resources Act. The water
2 rights held by the hydroelectric owners do not preclude the
3 State from seeking damages and rents. The State is not
4 precluded from presenting evidence based upon the shared
5 net benefits theory, taking into account the value of the
6 generation produced by the facilities. Finally, the damage
7 claims are not limited to the actual footprint of the dam
8 itself; the claim may include the use of upstream State-
9 owned riverbeds. Accordingly, only the question of
10 damages remained to be determined at trial, with the State
11 seeking in excess of \$200 million for prior trespass and
12 \$8.4 million per year for future rents.

13 **Q. What are the details for the settlement agreement**
14 **regarding the Montana riverbed lease issue?**

15 A. A settlement was reached between Avista and the
16 State of Montana in October 2007, on the eve of trial. It
17 represented the culmination of several months of settlement
18 discussions with the support of a mediator. On October 19,
19 2007, the Company reached a settlement with the State of
20 Montana resolving this matter. (See Exhibit No. 4, Schedule
21 3 "Memorandum of Negotiated Settlement Terms") Pursuant to
22 this settlement, Avista agreed to make lease payments in
23 the initial amount of \$4 million per year beginning
24 February 1, 2008, for the calendar year 2007, and
25 continuing through calendar year 2016, adjusted each year

1 by the Consumer Price Index (CPI), with no payment for
2 prior damages. The level of payments, the start date of
3 payments, as well as other settlement terms and conditions,
4 were all integral to the resolution of these claims.

5 On or before June 30, 2016, Avista and the State of
6 Montana will determine whether the annual lease payments
7 remain consistent with the principles of law as applied to
8 the facts and negotiate an adjusted lease payment for the
9 remaining term of Avista's FERC license for its
10 hydroelectric facilities on the Clark Fork River, which
11 expires in 2046. If Avista and the State of Montana do not
12 agree on an adjusted lease payment, the parties will engage
13 in advisory arbitration and submit the arbitrator's
14 recommendations to the State Board of Land Commissioners
15 ("Land Board") for approval. The settlement also contains
16 provisions that could reduce the amount of Avista's lease
17 payments as a result of future judicial determinations in
18 related cases or governmental actions. As mentioned,
19 Avista will not make any lease payments for the periods
20 prior to 2007.

21 **Q. Why did the Company settle the case instead of**
22 **going to trial?**

23 A. The Company decided to settle the case to avoid
24 liability for retroactive rents and to avoid a large
25 potential judgment against it. The State of Montana was

1 demanding over \$200 million for past rents combined with
2 ongoing lease payments of approximately \$8.4 million per
3 year. The settlement also stipulated that the Company
4 could reduce the amount of future lease payments if future
5 judicial determinants, court cases or governmental actions
6 indicated that a lower lease amount was appropriate.
7 Accordingly, the settlement avoids the potential costly
8 litigation and exposure to very substantial claims by the
9 State of Montana. The Noxon Rapids and Cabinet Gorge
10 hydroelectric projects are the Company's lowest-cost
11 resources and are integral to the Company's resource base.
12 The Company continues to make every effort to preserve the
13 generation from these projects for the benefit of its
14 customers at the lowest possible cost. Ms. Andrews has
15 included the Idaho share of these costs in her pro forma
16 adjustments.

17 **V. HYDRO RELICENSING**

18 **Q. Would you please provide an update on work being**
19 **done under the existing FERC operating license for the**
20 **Company's Clark Fork River generation projects?**

21 A. Yes. Avista received a new 45-year FERC
22 operating license for its Cabinet Gorge and Noxon Rapids
23 hydroelectric generating facilities on March 1, 2001. The
24 Company has made significant progress working in
25 collaboration with 27 signatories to the Clark Fork

1 Settlement Agreement toward meeting the goals, terms, and
2 conditions of the Protection, Mitigation and Enhancement
3 (PM&E) measures under the license. The implementation
4 program has resulted in the protection of approximately
5 2,500 acres of bull trout, wetlands, uplands, and riparian
6 habitat. The fish passage program, using electrofishing
7 and trapping with over 150 adults radio tagged and their
8 movements studied, has reestablished bull trout
9 connectivity between Lake Pend Oreille and the Clark Fork
10 River tributaries above Cabinet Gorge Dam. Avista has
11 worked with the U.S. Fish and Wildlife Service to develop
12 two experimental fish passage facilities. The testing of
13 these facilities has not produced a design that will
14 attract adult bull trout. However, studies will continue
15 to seek solutions for developing a volitional fish passage
16 facility. Juvenile bull trout on their downstream
17 migration are collected in tributary streams, tagged, and
18 transported to the Clark Fork River downstream of Cabinet
19 Gorge Dam to test the survival of adults. The costs
20 associated with the PM&E measures were reviewed in a prior
21 case and are included in retail rates.

22 Recreation facility improvements have been made to 30
23 sites along the reservoirs. Finally, tribal members
24 continue to monitor known cultural and historic resources
25 located within the project boundary to ensure that these

1 sites are appropriately protected. The costs associated
2 with the PM&E measures were reviewed in a prior case and
3 are included in retail rates.

4 Total dissolved gas levels occurring during spill
5 periods at Cabinet Gorge Dam was an unresolved issue when
6 the current Clark Fork license was received. The license
7 provided time to study the actual biological impacts of
8 dissolved gas and subsequent development of a dissolved gas
9 mitigation plan. The studies documented no biological
10 impact from dissolved gas below the project; however, the
11 stakeholders ultimately concluded that dissolved gas levels
12 should be mitigated, in accordance with federal and state
13 law. A plan to reduce dissolved gas levels was developed
14 with all stakeholders, including the Idaho Department of
15 Environmental Quality. The original plan called for the
16 modification of two existing diversion tunnels which could
17 redirect streamflows exceeding turbine capacity away from
18 the spillway. The plan originally called for modification
19 of the first tunnel by 2010 at an estimated cost of \$38
20 million. The second tunnel would only be constructed after
21 a performance analysis and an evaluation of the
22 environmental benefits of the first tunnel. The Company,
23 with the support of engineering contractors, spent several
24 years developing feasibility and cost studies to retrofit
25 the first tunnel.

1 **Q. Would you please provide an update on the current**
2 **status of the Cabinet Gorge Bypass Tunnels Project?**

3 A. Yes. The 2006 Preliminary Design Development
4 Report for the Cabinet Gorge Bypass Tunnels Project
5 indicated that the preferred tunnel configuration did not
6 meet the performance, cost and schedule criteria
7 established in the approved Gas Supersaturation Control
8 Plan (GSCP). Analysis of the predicted total dissolved gas
9 (TDG) performance indicated that the tunnel would increase
10 TDG by up to 18% rather than the 4% stipulated in the GSCP.
11 The total estimated cost of the first tunnel was determined
12 to be \$58 million, which is an increase of \$20 million over
13 the original estimate. The schedule for completion of the
14 first tunnel also slipped to March of 2012 instead of the
15 2010 date set by the GSCP. These findings led the Gas
16 Supersaturation Subcommittee to determine that the Cabinet
17 Gorge Bypass Tunnels Project is not viable to meet the
18 GSCP. The subcommittee is currently amending the plan with
19 alternatives to the original GSCP and the results are
20 expected by the end of 2008. With the completion of the
21 Bypass Tunnel analysis in 2008, the Company is proposing
22 recovery of these costs of approximately \$5.4 million in
23 this case through rate base treatment of the costs over the
24 remaining life of the Cabinet Gorge Project.

1 **Q. Would you please give a brief update on the**
2 **status of efforts to relicense the Spokane River**
3 **Hydroelectric Projects?**

4 A. Yes. The Company filed applications with FERC in
5 July 2005 to relicense five of its six hydroelectric
6 generation projects located on the Spokane River. The
7 Spokane River Project, which is currently under a single
8 FERC license, includes Long Lake, Nine Mile, Upper Falls,
9 Monroe Street, and Post Falls. Little Falls, the Company's
10 sixth project on the Spokane River, is not under FERC
11 jurisdiction, but operates under separate Congressional
12 authority. Our current license for the Spokane River
13 Project expired in August 2007. The Company is currently
14 operating under an annual license at this time, but expects
15 to receive a new 50-year license by the end of 2008.
16 Company Witness Mr. Howard provides detailed testimony
17 about the entire Spokane River Hydroelectric Project
18 relicensing process and costs associated with the
19 relicensing effort and Ms. Andrews has included the pro
20 forma costs in this case.

21 **VI. MERCURY ABATEMENT AT COLSTRIP**

22 **Q. Please provide a summary of the mercury abatement**
23 **project for Colstrip Units 3 and 4.**

24 A. Mercury emissions laws in Montana are going into
25 effect January 1, 2010 with a second phase going into

1 effect in 2018. Testing of two different mercury control
2 technologies was initiated at Colstrip to comply with the
3 new regulations. The tests did not meet the targets set by
4 the Montana Department of Environmental Quality, but
5 optimization of the mercury control systems is expected to
6 meet the required emissions levels. More testing is being
7 done at this time and we expect to begin full mercury
8 control operations by mid-2009 to ensure enough time to
9 fine tune the system with Colstrip plant operations.

10 The largest expense involved with the mercury control
11 project will be a significant increase in O&M costs. The
12 Company's share of the new O&M costs is expected to be
13 approximately \$3 million per year. The current capital
14 budget for Colstrip is estimated to be sufficient to meet
15 the capital expenditures for this project. This increase
16 in O&M costs is expected in June 2009, therefore Ms.
17 Andrews has included six months or \$1.5 million of the
18 annual expenditures in her pro forma adjustments in this
19 case.

20 **VII. JACKSON PRAIRIE STORAGE**

21 **Q. Can you please provide an overview of Avista's**
22 **involvement with Jackson Prairie Storage?**

23 A. Yes, the Jackson Prairie Storage Project is an
24 underground reservoir project located near Chehalis,
25 Washington. Avista was one of the three original

1 developers of this storage facility. Avista, Puget Sound
2 Energy and Northwest Pipeline own equal shares of this
3 underground storage facility. Development began in the
4 1960's and the project entered service in 1972. A number
5 of expansions have occurred since the facility opened and
6 Avista currently holds a total of 8,308,694 Dth of seasonal
7 capacity and 294,667 Dth of daily withdrawal capacity at
8 Jackson Prairie.

9 **Q. Is the Company participating in any other storage**
10 **expansion projects?**

11 A. Yes. In 2006, Avista and its partners started an
12 expansion project at Jackson Prairie (FERC Certificate in
13 CP06-412) for deliverability that will be in service in the
14 Fall of 2008 and will result in Avista's daily
15 deliverability increasing by 104,000 Dth.

16 **Q. What analysis was done to support the**
17 **deliverability expansion costs?**

18 A. Avista's performed analysis on the Jackson
19 Prairie deliverability expansion. This analysis compared
20 the total expected costs of current infrastructure and
21 supply compared to the total expected costs including the
22 deliverability expansion. Results showed the Company's
23 total costs were lower when including the deliverability
24 expansion. In addition to this review, the Company also

1 examined the potential for improved reliability of supply
2 and peak pricing mitigation benefits.

3 **Q. You mentioned improved reliability of supply,**
4 **please explain.**

5 A. The Company relies on monthly and longer-term
6 seasonal and annual contracts for supply to satisfy its
7 projected average daily demand. For daily swings in load,
8 above and below average, the Company relies on a
9 combination of storage and daily purchases and sales. In
10 today's market virtually all physical short-term purchases
11 are done at market hubs like Sumas/Huntingdon. While these
12 purchases are generally reliable there is a risk of
13 delivery failure. There are a number of reasons why
14 delivery risk can be problematic. First, using the
15 Sumas/Huntingdon Hub as an example, gas may change hands
16 (trade) three or four times between parties. The failure
17 of one party in the chain relying on interruptible
18 transportation, or a less than secure supply source, can
19 result in supply loss on any given day. A second reason is
20 that it only takes one scheduling error in the supply chain
21 to result in a supply loss. And third, actual physical
22 problems like well freeze-offs or pipeline force majeure
23 situations along the transportation path can also result in
24 supply loss. Access to additional storage deliverability

1 provides the Company with more control and therefore more
2 reliability of supply during these events.

3 **Q. Please explain what you mean by peak pricing**
4 **mitigation.**

5 A. As with most local distribution companies in the
6 Northwest, Avista's demand is extremely temperature
7 sensitive. The result is that Avista is a "winter peaking"
8 utility. During severe cold weather events in its service
9 territory, or cold events in large market centers on the
10 eastern seaboard, natural gas prices may increase
11 dramatically. To the extent that the Company can rely on
12 storage withdrawals, the purchase of potentially higher
13 priced spot gas may be avoided during these events.

14 **Q. You mentioned potentially higher spot prices; can**
15 **you identify the magnitude of these price deviations?**

16 A. Yes, the Company performed a frequency analysis
17 of Gas Daily pricing at Sumas/Huntingdon for the period
18 from January 1, 2000 to date. This analysis showed that
19 during this period the daily price exceeded \$10.00 per Dth
20 97 times and the average price for those occurrences was
21 \$13.77 per Dth. Approximately half of those occurrences
22 exceeded \$12.00 per Dth at an average price slightly over
23 \$17.00 per Dth.

24 **Q. How does additional daily deliverability from**
25 **storage benefit customers during these price deviations?**

1 A. As mentioned above, these price deviations
2 usually occur during periods of high demand. The ability
3 to withdraw larger volumes of storage gas on any day allows
4 the Company to directly offset higher costs that others in
5 the marketplace may have to bear.

6 **Q. What other benefits accrue to customers through**
7 **the Company's participation in expansion projects that**
8 **increase storage capacity and daily deliverability?**

9 A. The larger deliverability allows the Company to
10 deliver gas to its service territory utilizing currently
11 available transportation contracts for longer periods of
12 time before reaching the decline curve of the project. The
13 decline curve is the reduction of daily deliverability that
14 occurs as gas is withdrawn and the pressure in the field
15 declines. Jackson Prairie can currently provide 100% daily
16 deliverability until 40% of the working capacity has been
17 withdrawn. Then there is a gradual decline in
18 deliverability until the pressure and resulting working gas
19 in storage reaches contractual minimums.

20 **Q. How will the new daily deliverability be split**
21 **between Avista's service territories?**

22 A. The Company has firm demand in Idaho, Oregon and
23 Washington. The demand is split between Washington/Idaho
24 and Oregon on a 75%/25% basis. This demand allocation was
25 determined by using the estimated Oregon average load of

1 approximately 9.360 million Dth, in comparison to the
2 estimated Company total average load of approximately
3 36.833 million Dth in the Company's 2007-2008 procurement
4 Plan. The Company proposes to allocate this new
5 deliverability based on that ratio.

6 **Q. Is there any pipeline transportation capacity**
7 **available to provide delivery of these storage volumes?**

8 A. Yes, although no new capacity is available,
9 existing transportation contracts from Sumas can be used to
10 redeliver storage volumes. The Company will avoid a
11 portion of winter purchases and utilize storage as a
12 substitute for this supply. Therefore, the same
13 transportation contracts currently utilized for physical
14 supply purchases will be used for storage gas delivery.

15 **Q. Is the Company requesting specific rate relief or**
16 **accounting treatment for the cost of the Jackson Prairie**
17 **Storage deliverability expansion project at this time?**

18 A. Yes. The Company has included Idaho's share of
19 the Jackson Prairie deliverability expansion project cost.
20 The deliverability expansion will be completed in the fall
21 of 2008. At that time, the benefits associated with this
22 additional Jackson Prairie deliverability will begin
23 accruing to customers via the PGA mechanism. Ms Andrews
24 includes the Jackson Prairie expansion costs in her pro
25 forma adjustments in this case.

1 **Q. Has the company discussed the proposed allocation**
2 **of this new Jackson Prairie capacity, and associated costs,**
3 **with Commission Staff?**

4 A. Yes. The Company has had discussions with
5 Commission Staff and they have indicated initial support
6 for the Company's proposal in regards to the new Jackson
7 Prairie capacity as described above.

8 **VIII. AVISTA'S RISK MANAGEMENT POLICY**

9 **Q. Can you provide an overview of Avista's risk**
10 **management program for energy resources?**

11 A. Yes, Avista Utilities uses a variety of
12 techniques to manage the risks associated with serving load
13 and managing Company resources. The Company's risk
14 management approach uses price diversification by forcing a
15 layering strategy for forward purchases and sales, and by
16 using stop-loss price controls to protect against market
17 price run-ups and run-downs by utilizing upper and lower
18 price control limits. The Energy Resources Risk Policy
19 provides general guidance to manage the Company's energy
20 risk exposure, as it relates to electric power and natural
21 gas resources over the long (more than 18 months), short
22 (monthly and quarterly periods out to 18 months), and
23 immediate terms (present month). The purpose of the Risk
24 Policy is not to develop a specific procurement plan for
25 buying or selling power or natural gas for generation at

1 any particular time. Several factors, including the
2 variability associated with loads, hydroelectric
3 generation, and electric power and natural gas prices, are
4 considered in the decision-making process regarding
5 procurement of electric power and natural gas for
6 generation. The Risk Policy addresses the types of risks
7 that are covered, power and natural gas supply positions,
8 authorized transactions, resource optimization, reports,
9 credit and contracts, information systems, confirmation and
10 settlement, and employee conduct. There are also five
11 exhibits covering authorized products, the electric hedging
12 plan, the natural gas hedging plan, roles and
13 responsibilities, and transaction authority levels.
14 Exhibit No. 4, Schedule 4 is a copy of the Avista Utilities
15 Energy Resources Risk Policy.

16 **Q. What types of risks are addressed in the Risk**
17 **Policy?**

18 A. The Risk Policy defines several different types
19 of risk and how they are addressed by the Risk Policy.
20 Exhibit No. 4, Schedule 4 provides specific details
21 concerning each of these risks. The Risk Policy does not
22 supersede the responsibilities of other areas of the
23 Company that are responsible for other risk management
24 issues, such as Treasury, State and Federal Regulation, and
25 corporate Information Systems. The most relevant types of

1 defined risks addressed in the Policy are the mitigation of
2 market risks and the description and assignment of roles
3 and responsibilities in internal operations risks.

4 **Q. What is the power supply position and how does it**
5 **fit into the Risk Policy?**

6 A. The power supply position is the difference
7 between electric resources and requirements. Surplus
8 positions occur when resources exceed requirements and
9 deficits occur when requirements exceed resources. Power
10 supply position considers all of the variables that affect
11 short term power supply. The dynamic nature of the power
12 supply position is actively managed "by establishing
13 control processes for load and obligation estimation,
14 resource estimation, and management of the expected net
15 surplus or deficit position." All of these areas are under
16 my responsibility as the Vice President of Energy
17 Resources. The same types of position issues are also
18 addressed in regards to natural gas supplies. Any changes
19 to practices are communicated to the Risk Management
20 Committee.

21 Electric loads and obligations are estimated based upon
22 an analysis of historic loads, adjusting for weather
23 variability, expected additions or decreases in large
24 customer loads, all known wholesale contract obligations,
25 and adjustments, as necessary, based on analysis of prior

1 estimating accuracy and other factors. Electric resources
2 are estimated based on expected output after consideration
3 for variability in conditions such as streamflow, forced
4 outages, maintenance, and environmental concerns.

5 Electric surplus and deficit positions are hedged using
6 the electric hedging plan as a guide which can be deviated
7 from based on management judgment of each surplus or
8 deficit situation. All changes to the Short Term electric
9 position are reported every business day in an electric
10 position report.

11 **Q. Please describe the current electric hedging**
12 **plan.**

13 A. The electric hedging plan, detailed in Exhibit 2
14 of the Risk Policy (Exhibit No. 4, Schedule 4), relies
15 heavily upon the Hedge Scheduler. The Hedge Scheduler is
16 the analytical tool that the Company utilizes to guide
17 hedging positions over the next 14 to 18 months. The tool
18 manages open positions of 25 aMW of generation. Open
19 positions that are greater than 25 aMW are cured with
20 electric commodity transactions or fuel transactions.
21 Price control limits and time periods are employed to
22 trigger purchases or sales to cure open positions. The
23 curing transaction occurs whenever a price control limit is
24 exceeded or the cure period expiration date is crossed.
25 The Hedge Scheduler does not make the final decisions, but

1 is an important tool that is utilized to aid in management
2 discretion in the Company's electric hedging plan.

3 **Q. How does the Hedge Scheduler work?**

4 A. The Hedge Scheduler covers a period of time from
5 the next whole calendar month out to 14 to 18 months. The
6 14 to 18 month electric load and resource forecast is used
7 by the Hedge Scheduler to model a series of transactions to
8 "systematically reduce the net open position" (the gap
9 between expected load obligations and projected power
10 resources) which limits the Company's projected financial
11 exposure to less than 25 aMW in any given month. The
12 transactions are generally in 25 aMW increments which
13 include a mixture of electric commodity purchases or fuel
14 transactions (natural gas purchases to fuel thermal
15 generation).

16 The actual operation of the Hedge Scheduler utilizes
17 separate schedules for on- and off-peak positions. The
18 position is cured in 25 aMW pieces where price limits are
19 established based on the price volatility for the delivery
20 period. Upper and lower confidence limits are initially
21 established as the standard deviation of the prior 365 days
22 of forward prices for the delivery period being considered.
23 The values are centered around the set price. The periods
24 are established by calculating the time remaining divided
25 by the number of 25 aMW pieces that need to be cured.

1 **Q. What is hydro bias and how does it affect the**
2 **Electric Hedging Plan?**

3 A. Hydro bias is a physical power quantity held in
4 the load and resource position to protect against below
5 normal hydro conditions. Abnormal hydro conditions can
6 result in significant price risk, particularly in the
7 upward direction. In low hydro conditions, purchasing
8 power in the spot market can result in high upside price
9 risk up to the \$400/MWh price cap. During high hydro
10 conditions, there is downside price risk associated with
11 selling excess power in an oversupplied market, but the
12 price cannot go below zero. The Hydro Bias is used in the
13 Hedge Scheduler to provide a conservative estimate for
14 hydro generation which mitigates the potentially adverse
15 financial impacts of poor hydro conditions. The allowance
16 for lower than normal hydro conditions is recognized as an
17 estimated power obligation within the current (18 month
18 forward period) hydro operating year. The size of the
19 Hydro Bias is developed by analyzing generation variability
20 under historic conditions from the 70-year hydro record
21 (1928-1998). Above normal hydro conditions are limited to
22 normal levels, while below normal conditions are left in
23 tact. These levels are multiplied by a one standard
24 deviation confidence factor to determine the Hydro Bias
25 value. The Hydro Bias decreases as the delivery period

1 approaches and better hydro forecasts are available. The
2 Hydro Bias goes to zero before the delivery month is
3 reached.

4 **Q. Could you please describe when and what triggers**
5 **purchases or sales of natural gas for thermal generation**
6 **used to serve load?**

7 A. Yes, the Hedge Scheduler triggers described above
8 provide a guideline for when to purchase or sell power or
9 fuel. When a transaction is indicated by the Hedge
10 Scheduler, either purchase or sale, the economics of
11 thermal plants are evaluated for the period to determine if
12 the power needed should be met with gas generation. (A
13 portion of the daily position report analyzes the "Economic
14 Fuel Requirements" of each gas-fired thermal plant.) If a
15 need for power is indicated by the Hedge Scheduler and a
16 thermal plant is economic and available for the time
17 period, natural gas is purchased to resolve the trigger.
18 The thermal resources are evaluated daily to determine if
19 any previously-purchased natural gas has become uneconomic
20 versus the forward power market. When uneconomic natural
21 gas has been verified by market quotes, the natural gas is
22 sold and power is purchased to replace the reduction in
23 generation. Although the transaction may result in a loss
24 on the gas sale, the lower cost of the power being

1 purchased offsets the loss and the net impact is always a
2 benefit to customers.

3 **Q. How do natural gas purchases for thermal**
4 **generation impact the power supply position?**

5 A. The volume of power generation resulting from
6 natural gas purchases is included as a resource in the
7 power supply position calculation. To the extent that
8 fixed price (i.e. hedged) natural gas has not been
9 purchased for a thermal plant, the generation for that
10 plant is not counted as a resource in the power supply
11 position.

12 **Q. What is the impact of the hedge scheduler on the**
13 **cost of gas for generation?**

14 A. The hedge scheduler causes gas purchases for
15 generation to be purchased in layers over time. As
16 economic purchases and sales are made, the gas price
17 reflects the market at the time the transaction is made.
18 This results in a cost of gas that is an average of all the
19 transactions rather than a price at a point in time.

20 **Q. What are the benefits of the "hedge scheduler"**
21 **approach?**

22 A. The hedge scheduler causes long or short power
23 positions to be resolved over time. The benefits of this
24 approach are: it layers in purchases and sales of power and
25 fuel over a rolling period of time so that all purchases or

1 sales are not made when prices may be unusually high or
2 low; it allows purchases and sales to occur as more and
3 better information comes available on generation resources
4 (e.g. snow pack, rainfall, and hydro conditions) and loads;
5 and it resolves open positions by the time we get to the
6 relevant period.

7 **Q. How are transactions authorized in the Risk**
8 **Policy?**

9 A. The Risk Policy establishes parameters for
10 different types of transactions. These parameters specify
11 individuals and positions along with the types and lengths
12 of transactions they are authorized to carry out. The
13 details of transaction authorizations are provided in
14 Exhibit 1 of the Risk Policy (Exhibit No. 4, Schedule 4).

15 **Q. Are other topics covered in the Risk Policy?**

16 A. Yes. Besides subjects that are specifically
17 related to non-fuel gas resources, there are a variety of
18 areas that are covered under the Risk Policy. These areas
19 include reports, credit terms, counterparty contracts,
20 information systems, confirmation and settlement, employee
21 conduct, and risk policy updates. Additional details about
22 these areas are contained in Exhibit No. 4, Schedule 4.

23 **Q. Does this conclude your pre-filed direct**
24 **testimony?**

25 A. Yes it does.

RECEIVED

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IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)	CASE NO. AVU-E-08-01
OF AVISTA CORPORATION FOR THE)	CASE NO. AVU-G-08-01
AUTHORITY TO INCREASE ITS RATES)	
AND CHARGES FOR ELECTRIC AND)	
NATURAL GAS SERVICE TO ELECTRIC)	EXHIBIT NO. 4
AND NATURAL GAS CUSTOMERS IN THE)	
STATE OF IDAHO)	DENNIS P. VERMILLION
)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

Integrated Resource Plan (IRP)

Compact Disc Exhibit

Also Available At

<http://www.avistautilities.com/inside/resources/irp/electric/Pages/default.aspx>

AVU-E-08-01 / AVU-G-08-01

**DENNIS P. VERMILLION'S
EXHIBIT 4**

**SEE THE FILE FOLDER
FOR THE CD OF AVISTA'S
2007 ELECTRIC
INTEGRATED RESOURCE
PLAN – IT IS ALSO
AVAILABLE
ELECTRONICALLY IN
CASE NO. AVU-E-07-08**

**BACKGROUND OF SETTLEMENT OF CLAIMS
BETWEEN AVISTA CORPORATION AND
STATE OF MONTANA**

(10/31/07)

1. **Introduction.**

Avista Corporation's federally licensed Clark Fork Project is located on the Clark Fork River, a tributary of the Columbia River. The Clark Fork Project includes the 527 megawatt Noxon Rapids dam and reservoir located in Montana and the 261 megawatt Cabinet Gorge Dam located in Idaho near the Montana-Idaho border. The reservoir for the Cabinet Gorge Dam is located almost entirely in Montana.

In October 2003, Richard Dolan and Denise Haymen, residents of Bozeman, Montana with children in Montana's public school system, filed an action in U.S. District Court in Missoula, Montana against Avista Corporation ("Avista"), PPL Montana, LLC, ("PPL Montana") and PacifiCorp (collectively "Hydroelectric Owners"). Shortly thereafter, Dolan and Haymen were joined by school districts from Great Falls, Montana, which sought to intervene as additional party plaintiffs.¹ Together, the Private Plaintiffs alleged that the State's riverbeds are being utilized by the Hydroelectric Owners, that those riverbeds are "School Trust Lands" under the Montana Constitution, and that compensation is owed by the Hydroelectric Owners to the State on account of their use and occupancy of State lands.

In March 2004, the State of Montana, through the Attorney General, intervened as a party plaintiff in the action. Ultimately, however, the Federal District Court dismissed the lawsuit,

¹ Dolan, Haymen and the Great Falls School Districts are collectively referred to herein as the "Private Plaintiffs."
Exhibit No. 4
Case No. AVU-E-08-01 & AVU-G-08-01
D. Vermillion, Avista
Schedule 2, p. 1 of 10

concluding that the Private Plaintiffs lacked standing and that the Court did not possess jurisdiction over the matter.

In November 2004, the Hydroelectric Owners filed a declaratory judgment action in Montana District Court in Helena, Montana. In response, the State filed an Answer, Counterclaims and a Motion for Summary Judgment. Because it represented a case of first impression in Montana and the United States, the litigation resulted in briefing and rulings on numerous issues of Constitutional and statutory significance. It further resulted in three major court hearings, consisting of multiple hours of oral arguments before the Montana District Court; extensive discovery, including the exchange of thousands of pages of written documents; and the depositions of 35 party representatives, experts and related witnesses.

In June 2006, PacifiCorp and the State entered into a voluntary settlement, and PacifiCorp was subsequently dismissed from the lawsuit. On October 19, 2007—just three days prior to trial and with the State's damage claim still pending, Avista and the State also entered into a voluntary settlement. Trial of the State's claims against PPL Montana began on October 22, 2007. Those proceedings are ongoing as of this date.

2. **Nature of the Lawsuit.**

The claims of the Private Plaintiffs, subsequently echoed by the Montana Attorney General's pleadings in both federal and state court, are summarized, in pertinent part, as follows:

- a) The beds of navigable waters within Montana's borders became the property of the State under the "Equal Footing" doctrine of the United States Constitution. That doctrine provides that, upon their entry to statehood, the states assumed ownership of the lands beneath navigable waters on an equal footing with the thirteen original states.
- b) Under the Montana Constitution, the lands beneath navigable waters within the State are "School Trust Lands." Under Montana law, the State has a fiduciary obligation to collect full market value for the use of such lands on behalf of the Montana School Trust.

- c) In 1931, Montana enacted the Montana Hydroelectric Resources Act, which requires a license or lease for the occupancy of State-owned lands. Although never before interpreted or applied to the Hydroelectric Owners' facilities in Montana, the Act requires those intending to use state-owned lands to apply for a lease and pay full market rental for such use.
- d) The rental obligations of the Hydroelectric Owners began when they constructed the hydroelectric projects at issue. Therefore, damages owed to the State go back to the original construction of the projects, without regard to any statute of limitations that might otherwise apply.
- e) Avista has wrongfully occupied the Clark Fork River through its operation of the Noxon Rapids Dam and Reservoir, which are wholly located in the State of Montana. Likewise, although the Cabinet Gorge Dam is located in Idaho, most of the Cabinet Gorge Reservoir is located in Montana and, as a consequence, its operation by Avista also results in the wrongful occupation of State-owned lands.²
- f) As applied to Avista, the State is entitled to past damages from 1954 to the present, together with future rents at the full market rental value of the land.

3. Potential Exposure.

The State of Montana employed Dr. John Duffield, a professor at the University of Montana who is well-known for his expertise in the calculation of natural resource damages, as its expert economist. Dr. Duffield employed a "shared net benefits" methodology to measure the purported damages owed to the State by virtue of the Hydroelectric Owners' occupancy of State-owned lands. Previously, the shared net benefits methodology had been applied only by the Federal Energy Regulatory Commission and federal courts in determining the amount of annual charges to be paid to Indian Tribes under Section 10(e) of the Federal Power Act. Only the State of Maine had applied the methodology in a case not involving tribal lands.

Prior to Dr. Duffield's June 2007 report, the precise magnitude of the State's damage claim was not fully known. In his report, however, Dr. Duffield asserted that, based upon the State's claimed ownership of all lands beneath the navigable waters at issue, Avista owed the

² Although discovery had been conducted regarding the Cabinet Gorge Dam, the facility was not officially incorporated into the case until the State sought to amend its Counterclaim to conform the evidence on the eve of trial.

State in excess of \$542,000,000 for cumulative past rents, and in excess of \$24,000,000 for current 2006 rent, with annual rental payments to continue, as adjusted, for the remaining term of Avista's FERC license (i.e., until 2046).

The initial litigation position of the State concerning damages was revised after the District Court granted Avista and PPL Montana's motion that certain submerged land under the reservoirs was not owned by the State, and that only the original streambeds were at issue. The revised litigation position of the State, as filed with the District Court on October 15, 2007, was that the full market value rental due on Avista's Clark Fork Project was \$200,374,752 for past occupation, together with future rents of \$8,416,510 per year starting in 2006, to be adjusted annually by the Consumer Price Index with a recalculation of the original base amount every 10 years according to the shared net benefits methodology.

As the Counterclaim Defendant, Avista asserted that the State had the burden of proving its ownership of the lands at issue, the precise acreage of those lands, and the proper measure of damages. In addition, Avista was prepared to offer into evidence the testimony of Dr. Thomas Zepp, an economist from Salem, Oregon with extensive knowledge and experience in utility economics and regulation, as well as the shared net benefits methodology. Dr. Zepp was prepared to testify that Dr. Duffield's methodology resulted in a substantial overstatement of potential rents owed by Avista. Additionally, Avista was prepared to introduce testimony from Bruce M. Jolicoeur, MAI, a certified land appraiser in the States of Montana, Idaho and Washington, that the appropriate method of valuing riverbed lands is by reference to adjoining riparian lands.

For its part, PPL Montana employed Dr. Gary Saleba, another regionally known expert on utility economics, as its principal damages witness. His conclusions, although somewhat

different in method, were expected to be very similar to the conclusions of Dr. Zepp and Mr. Jolicoeur.

4. **Litigation Summary.**

The initial claims filed by the Private Plaintiffs were subsequently adopted by the State Attorney General and, as discussed below, were later reinforced by the rulings of the Montana District Court.

To defend the action, Avista retained, as joint counsel, the law firms of Paine Hamblen LLP of Spokane, Washington--a firm with extensive history representing both publicly and privately owned utilities, including in cases involving the shared net benefits methodology; and Garlington, Lohn & Robinson, PLLP of Missoula, Montana--a respected and long-established Montana law firm. PPL Montana and PacifiCorp, respectively, retained K&L Gates of Seattle and Stoel Rives LLP of Seattle as their primary counsel, as well as Montana-based counsel.

In response to the Complaint of the Private Plaintiffs, and similarly in response to the state court Complaint of the State of Montana, Avista initially moved the Federal Court to dismiss the action on the grounds that federal law preempts Montana law to the extent that the latter requires payment of rents by federally licensed Hydroelectric Owners. Additionally, Avista moved to dismiss the Private Plaintiffs for lack of standing. PPL Montana and PacifiCorp filed similar motions.

The Federal District Court ruled against the Hydroelectric Owners on the issue of federal preemption, but granted their motions to dismiss the Private Plaintiffs for lack of standing. Subsequently, the Hydroelectric Owners filed motions to dismiss the federal court action on the grounds that the Court lost jurisdiction of the matter when it dismissed the Private Plaintiffs. In response, the Federal Court dismissed the lawsuit and vacated its prior rulings.

Thereafter, in November 2004, the Hydroelectric Owners initiated a declaratory judgment action in Montana State District Court in Helena, Montana. In response, the State filed an Answer, Counterclaim and a Motion for Summary Judgment. Likewise, Avista, PPL Montana and PacifiCorp filed various motions asserting, among other things, the defenses of federal preemption, prescriptive easement, estoppel, laches, statute of limitations, waiver and breach of agreement. These motions were heard by the Montana District Court on June 28, 2005, at which time they were taken under advisement. In April 2006, the District Court ruled that (a) neither the Federal Power Act nor the Federal Navigation Servitude facially preempted the State from obtaining rental compensation under the Montana Hydroelectric Resources Act; and (b) that the Hydroelectric Owners' equitable defenses were unavailable against the State. In addition, the Court rejected Avista's attempts to assert the Clark Fork Settlement Agreement (an agreement involving Montana, Idaho and other stakeholders in the relicensing of Avista's Clark Fork Project) as a defense to the State's Counterclaim. The Court did, however, allow Avista to challenge the navigability of the Clark Fork River (later ruling, however, that it was navigable).

Following these decisions, the District Court established a procedural schedule for discovery, disclosure of expert reports and filing of dispositive motions. Trial was originally scheduled to begin, without a jury, on October 15, 2007. Between 2006 and 2007, the parties exchanged thousands of pages of documents in discovery, prepared and exchanged detailed expert reports and conducted 35 depositions of party representatives, experts and other witnesses.

In late 2006, a second series of motions for summary judgment and motions to exclude evidence were filed by the parties. In total, the parties filed over 1,300 pages of briefs, not including exhibits, on the many legal issues raised by the proceedings. In September and October, 2007, the Montana District Court issued orders on pending motions. Among other things, the District Court made the following determinations as a matter of law:

- a) The Clark Fork River is navigable for purposes of establishing the State's claim to title;
- b) The State owns the beds of the Clark Fork River and may charge rent to Hydroelectric Owners for their use;
- c) Riverbed lands are School Trust Lands;
- e) There are no statutes of limitation or equitable defenses that limit the State's claims with respect to School Trust Lands and, as a consequence, the State may seek damages back to the original construction of the dams at issue;³
- f) Because the lands in question are School Trust Lands, rents are owed by Hydroelectric Owners under the Montana Hydroelectric Resources Act for their use and occupancy;
- g) Water rights held by the Hydroelectric Owners do not preclude the State from seeking damages and rents;
- h) The State is not precluded from presenting evidence of its damages based upon a "shared net benefits" theory; and
- i) The State's damage claim is not limited to the physical footprint of the dam itself, but may extend to include the use of upstream riverbeds owned by the State.

The District Court also ruled that State's ownership interest extends only to the riverbed lands before the dams were built, and does not extend to lands that were subsequently inundated as a result of the Hydroelectric Owners' projects. This ruling was significant, as it diminished the potential recovery of the State by nearly two-thirds. Nonetheless, as a result of the District Court's other rulings, the State was granted the right to seek damages from Avista back to 1954.

Avista and PPL Montana sought interlocutory review of the District Court's rulings by the Montana Supreme Court. With one dissent, the Montana Supreme Court declined to exercise interlocutory jurisdiction, meaning that the parties would be forced to wait until a final judgment was entered before seeking appellate review of the District Court's rulings.

³ Although the Court had earlier addressed the statute of limitations as a defense, it had not considered Avista's additional argument that the Montana Code § 27-1-318, limits a party's relief for certain claims to five years. Significantly, the Court's subsequent decision on this issue against the Company (thereby exposing the Company to damages back to 1954) was received just hours after the settlement between Avista and the State was reached. If received earlier, it may have impacted the State's willingness to waive all of its claim for past damages.

As a result of the District Court's rulings in September and October 2007, the following issues remained to be determined at trial:

- a) The acreage of the State-owned lands at issue;
- b) The appropriate method for determining prospective rentals and retroactive damages; and
- c) The amount of such rentals and damages.

As stated before, the State's trial position, as set forth in the Pretrial Order entered with the Court, was that Avista owed \$200,374,752 in damages accruing back to 1954, and \$8,416,510 on an annual basis going forward, adjusted annually by the Consumer Price Index.

5. Settlement Discussions and Mediation.

Beginning in late 2006, Avista initiated a series of informal settlement discussions with the State⁴. In furtherance of those efforts, on September 6 and 7, 2007, a mediation was conducted in Helena, Montana by Jack Mudd, a respected former Dean of the University of Montana Law School. At that time, however, Avista and the State were unable to bridge the gap between the State's expected level of damages and Avista's settlement position. Informal discussions continued, and on October 17, 2007, representatives of Avista and the State met in Helena for a final effort, on the eve of trial, to arrive at a mutual settlement. This final round of negotiations resulted in a tentative settlement that was subsequently memorialized in a *Memorandum of Negotiated Settlement Terms*, dated October 19, 2007. A copy of that Memorandum is attached to the Petition as Appendix 2.

6. Terms of Settlement.

For purposes of settlement, Avista has agreed to pay rent to the State each year, beginning in the calendar year 2007, in the amount of \$4,000,000 per year. These rental

⁴ PacifiCorp settled with the State in June, 2007. The amount of the settlement in annual rentals is between \$50,000 and \$60,000, which reflects the very small size of the PacifiCorp project at issue (only 4 Mws.)

payments are to be made in arrears, with payment due on or before each February 1 for the previous calendar year. Rent will be adjusted each year by the Consumer Price Index (CPI) annual average for the calendar year for which payment is due. The State has agreed that the payment of such rent represents the full market value of Avista's use of the Clark Fork River. No later than June 30, 2016, Avista and the State will meet and confer to review the terms of the lease for the balance of the term of Avista's license, with advisory arbitration in the event of disagreement. As part of the settlement, the State has also agreed to waive its claim to past damages of \$200,374,752 in its entirety.

The parties have also agreed to jointly move the District Court to enter the terms of the *Memorandum of Negotiated Settlement Terms* as part of a final judgment in a Consent Decree.

7. **Favorable Aspects of the Memorandum of Negotiated Settlement Terms.**

The negotiated terms of the parties' settlement presents a favorable resolution to Avista of hotly contested matters, particularly taking into account the primary elements of the settlement.

These include the following:

- a) The negotiated annual rent on a prospective basis represents only 48% of the State's litigation position, as set forth in the Pretrial Order (\$8.4 million). Significantly, the State will also not receive any retroactive or historical damages, notwithstanding the Montana District Court's rulings that would have allowed evidence of such damages (the state was claiming \$200 million).
- b) Assuming that PPL Montana, which remains in the case, achieves a more favorable outcome at trial or through settlement, Avista will receive the benefit of that outcome. In particular, if the aggregate annual rent determined by settlement or litigation for PPL Montana is less than 48% of the base year rent claimed from PPL Montana by the State in its case-in-chief, Avista's aggregate annual rent will be decreased proportionally.
- c) If subsequent governmental action within Montana results in a rental payment more favorable to Avista than the rent calculated under the *Memorandum of Negotiated Settlement Terms*, the rent paid by Avista will be modified to incorporate the more favorable terms.

- d) If, during the term of Avista's FERC license, a court determines that i) the Clark Fork River is not navigable for title purposes, ii) the shared net benefits method is not a lawful method of calculating the full market value of land interests, or iii) no compensation or reduced compensation in the nature of rentals is owed to Montana for occupancy of State-owned riverbeds, and the application of such determination or determinations would result in a rental payment more favorable to Avista, or otherwise extinguish Avista's obligation of pay rentals, Avista's obligation to pay rent will be modified.

By virtue of these provisions, the *Memorandum of Negotiated Settlement Terms* insures to Avista and its customers the up-side benefits of any subsequent governmental actions or judicial determinations in Montana. Although these types of re-openers or off-ramps are uncommon in litigation, it is a fair accommodation to the interests of Avista and its customers in this case.

Finally, it should be remembered that the Montana Supreme Court is the author of the cases upon which the State's School Trust Land rental obligation is predicated. Moreover, any appeal from an unfavorable ruling by the Montana Supreme Court would have to be taken to the United States Supreme Court, which accepts review in only a small percentage of cases submitted to it, and which may be reluctant to interfere with the Montana Supreme Court's interpretation of its own state laws. Therefore, considering the risks of continued litigation, together with the limited potential for a successful appeal, the settlement reflects a reasonable compromise, and a fair accommodation to the interests of Avista and its customers.

Memorandum of Negotiated Settlement Terms
October 19, 2007

This memorandum outlines the key terms of the agreement in principle reached between Avista Corporation and the State of Montana to resolve all issues pending between them in Cause No. CDV 2004-846, Mont. First Judicial District Court, Lewis & Clark County.

1. **Rent.** For purposes of settlement Avista agrees to pay rent to the State each year beginning calendar year 2007, and continuing through the remaining term of Avista's FERC license for the Clark Fork Project. Avista acknowledges that the State owns 3,158 acres of riverbed within the Clark Fork Project. The State acknowledges that the rent represents the full market value of the State interest or estate being used by Avista in connection with its operation of the Clark Fork Project (which includes both the Noxon Rapids project, and that portion of the Cabinet Gorge project within Montana). Rent will be paid in arrears, with payment due on or before each February 1 for the previous calendar year. The initial amount of the rent will be \$4 million per year. The rent will be adjusted each year as follows:

a. Beginning with calendar year 2008, and continuing through calendar year 2016, the base amount of \$4 million per year shall be adjusted upward by the Consumer Price Index (CPI) annual average for the calendar year for which payment is due.

b. Not later than June 30, 2016, the parties will meet and confer to determine whether the annual rental remains consistent with the principles of law as applied to the facts. In the event either party believes the annual rental no longer is consistent with applicable law applied to the facts, the parties will negotiate in good faith to determine an appropriate adjusted rental rate. If the parties do not agree upon an adjusted rental rate by September 30, 2016, the parties will engage in advisory arbitration and submit the arbitrator's recommendation to the State Board of Land Commissioners ("Land Board") for approval.

2. **Lease Terms.** The parties agree to jointly recommend to the Land Board a lease of a power site pursuant to the provisions of the Hydroelectric Resources Act, Mont. Code Ann. §§ 77-4-201, *et seq.* As part of that recommendation, the State and Avista agree to stipulate that the rent agreed upon by the parties represents full market value for the lease of 3,158 acres of Clark Fork riverbed being used by Avista in connection with the Clark Fork Project. The duration of the lease will be not less than the remaining term of Avista's FERC license.

3. **Most Favored Nations Clause.** If co-party PPL Montana, LLC, either by litigation through judgment and any appeals, or through settlement, receives a determination that the full market value of its land interests at issue in the litigation is based upon factors more favorable to it than those contained in the settlement with

Avista, the Avista rent will be adjusted by an amount necessary to reflect the more favorable determination. For purposes of this clause, a more favorable determination will occur if the aggregate annual rent determined by settlement or litigation for PPL Montana ("Determined PPL Rent") is less than 48% of the aggregate amount of base year rent ("Claimed PPL Rent") claimed by the State in its case in chief at trial. If this occurs, the \$4 million base rent to be paid by Avista shall be reduced retroactively starting on the date of final judgment on the PPL Montana claims or settlement by a percentage equal to the Determined PPL Rent divided by the Claimed PPL Rent. See Attachment A for an illustration of the calculation.

4. **Reopener for Subsequent Governmental Action.** If, during the term of the Avista lease, the Land Board, the Montana Legislature, the Department of Natural Resources and Conservation, or any other State entity with jurisdiction, enacts or adopts a rental statute, rule, or policy applicable to leases issued under the Hydroelectric Resources Act that would result in a rent payment more favorable to Avista than the rent calculated under paragraph 1, the rent paid by Avista shall be modified retroactively starting on the date of enactment or adoption to incorporate the more favorable terms.

5. **Reopener for Subsequent Judicial Determination.** If, during the term of the Avista lease, the reach of the Clark Fork River within the boundaries of Avista's FERC license is determined by a court of competent jurisdiction to be not navigable for title purposes, Avista's obligation to pay rent shall cease. If, during the term of the Avista lease, a court of competent jurisdiction determines that (a) the shared net benefits method is not a lawful method to calculate the full market value of land interests; or (b) no compensation or reduced compensation in the nature of rentals is owed to the State of Montana for occupancy of state-owned riverbeds, and the application of such determination or determinations would result in a rent payment more favorable to Avista than the rent calculated under paragraph 1, or otherwise extinguish Avista's obligation to pay rentals, Avista's obligation to pay rent will be modified retroactively starting on the date of determination to reflect a method of calculating rent that is consistent with the court determination or determinations, or Avista's obligation to pay rent shall cease, accordingly.

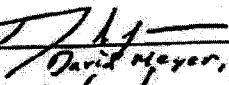
6. **Consent Decree.** The parties will agree on the form for, and jointly move the entry as a final judgment of, a consent decree that: (a) incorporates the terms of this Memorandum; (b) contains full releases of Avista and the State for all matters at issue in the litigation; (c) allows for appropriate public notice and comment; (d) certifies that Avista is in full compliance with the terms of the Hydroelectric Resources Act; and (e) includes appropriate other terms such as dispute resolution, force majeure and so forth.

STATE OF MONTANA

By: 
Matthew Stone, ASST. A. G.

Date: OCT. 19, 2007

AVISTA CORPORATION

By: 
David Meyer, V.P. and Chief Counsel for
Regulatory/Governmental
Affairs

Date: 10/19/07

ATTACHMENT A

If the Determined PPL Rent is less than 48% of the Claimed PPL Rent, Avista annual rent shall be recalculated according to following formula:

Annual Recalculated Avista Rental = $A \times (D + C)$ Where:

A = \$8,416,510 (Amount of annual rent claimed by the State in the State's Contention 9.A of the Pretrial Order)

D = Determined PPL Rent

C = Claimed PPL Rent set forth in State's case in chief

As an illustration, if Determined PPL Rent is \$3,000,000, and the Claimed PPL Rent is \$7,252,804, the Annual Avista Rental would be calculated as follows:

Annual Recalculated Avista Rental: $\$3,481,347 = \$8,416,510 \times (\$3,000,000 + \$7,252,804)$

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Avista Utilities Energy Resources Risk Policy

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Exhibit No. 4
Case No. AVU-E-08-01 & AVU-G-08-01
D. Vermillion, Avista
Schedule 4, p.1 thru 25