

BEFORE THE

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IDAHO PUBLIC UTILITIES COMMISSION

IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)
 OF AVISTA CORPORATION FOR THE)
 AUTHORITY TO INCREASE ITS RATES)
 AND CHARGES FOR ELECTRIC AND)
 NATURAL GAS SERVICE TO ELECTRIC)
 AND NATURAL GAS CUSTOMERS IN THE)
 STATE OF IDAHO.)
)
)
)

CASE NO. AVU-E-09-1/
AVU-G-09-1

DIRECT TESTIMONY OF TERRI CARLOCK

IDAHO PUBLIC UTILITIES COMMISSION

MAY 29, 2009

1 Q. Please state your name and address for the
2 record.

3 A. My name is Terri Carlock. My business
4 address is 472 West Washington Street, Boise, Idaho.

5 Q. By whom are you employed and in what
6 capacity?

7 A. I am the Deputy Administrator of the
8 Utilities Division at the Idaho Public Utilities
9 Commission. I am responsible for the Accounting/Audit
10 Section and coordinating Staff's policy positions with
11 Staff Administrator Randy Lobb.

12 Q. Please outline your educational background
13 and experience.

14 A. I graduated from Boise State University in
15 1980, with B.B.A. Degrees in Accounting and Finance. I
16 have attended various regulatory, accounting, rate of
17 return, economics, finance, and ratings programs. I am
18 currently the Chair of the National Association of
19 Regulatory Utilities Commissioners (NARUC) Staff
20 Subcommittee on Accounting and Finance. I also Co-chair
21 the Task Force on International Financial Reporting
22 Standards. I previously chaired the NARUC Staff
23 Subcommittee on Economics and Finance for more than 3
24 years. Under this subcommittee, I also chaired the Ad
25 Hoc Committee on Diversification. I have been a

1 presenter for the Institute of Public Utilities at
2 Michigan State University and for many other conferences.
3 Since joining the Commission Staff in May 1980, I have
4 participated in audits, performed financial analysis on
5 various companies, and have presented testimony before
6 this Commission on numerous occasions.

7 Q. What is the purpose of your testimony in
8 this proceeding?

9 A. The purpose of my testimony is to present
10 the Staff's recommendation related to the overall cost of
11 capital for Avista Corporation (Avista) to be used in the
12 revenue requirement in these cases, AVU-E-09-1 and AVU-G-
13 09-1. I will address the appropriate capital structure,
14 cost rates and the overall rate of return.

15 Q. Please summarize your testimony.

16 A. In my testimony on the overall rate of
17 return, I am recommending a return on common equity in
18 the range of 9.5% - 10.5% with a point estimate of 10.5%.
19 The recommended overall weighted cost of capital is in
20 the range of 8.05% - 8.55% with a point estimate of 8.55%
21 to be applied to the rate base for the test year.

22 Q. Are you sponsoring any exhibits to accompany
23 your testimony?

24 A. Yes, I am sponsoring Staff Exhibit No. 119
25 consisting of 2 schedules.

1 Q. Have you reviewed the testimony and exhibits of
2 Avista witnesses Avera and Thies associated with the
3 return components?

4 A. Yes. Much of the theoretical approach used by
5 Avista witness Avera in his testimony and exhibits is
6 generally similar to what I have used. My judgment in
7 some areas of application results in different outcomes.

8 Q. Avista witness Thies discusses the progress
9 made by Avista in improved financial health. Do you
10 agree?

11 A. Yes, I do. Several years ago Avista discussed
12 its plan to improve its financial health including
13 spreading its debt maturities over a number of years.
14 Progress has definitely been made in this area as
15 demonstrated by the rating upgrades. On May 19, 2009,
16 Fitch upgraded Avista's Senior secured debt to BBB+ from
17 BBB with a Stable Rating Outlook. This definitely moves
18 toward the goal stated by Company witness Thies,
19 "Avista's goal is to operate at a level that will support
20 a strong corporate credit rating of BBB/BBB+...." (Thies
21 testimony page 5).

22 Q. What legal standards have been established for
23 determining a fair and reasonable rate of return?

24 A. The legal test of a fair rate of return for a
25 utility company was established in the *Bluefield Water*

1 Works decision of the United States Supreme Court and is
2 repeated specifically in *Hope Natural Gas*.

3 In *Bluefield Water Works and Improvement Co. v.*
4 *West Virginia Public Service Commission*, 262 U.S. 679,
5 692, 43 S.Ct. 675, 67 L.Ed. 1176 (1923), the Supreme
6 Court stated:

7 A public utility is entitled to such rates as
8 will permit it to earn a return on the value
9 of the property which it employs for the
10 convenience of the public equal to that
11 generally being made at the same time and in
12 the same general part of the country on
13 investments in other business undertakings
14 which are attended by corresponding risks and
15 uncertainties; but it has no constitutional
16 right to profits such as are realized or
17 anticipated in highly profitable enterprises
18 or speculative ventures. The return should
19 be reasonably sufficient to assure confidence
20 in the financial soundness of the utility and
21 should be adequate, under efficient and
22 economical management, to maintain and
23 support its credit and enable it to raise the
24 money necessary for the proper discharge of
25 its public duties. A rate of return may be
reasonable at one time and become too high or
too low by changes affecting opportunities
for investment, the money market and business
conditions generally.

19 The Court stated in *FPC v. Hope Natural Gas Company*, 320
20 U.S. 591, 603, 64 S.Ct. 281, 88 L.Ed. 333 (1944):

21 From the investor or company point of view it
22 is important that there be enough revenue not
23 only for operating expenses but also for the
24 capital costs of the business. These include
25 service on the debt and dividends on the
stock.

1 ... By that standard the return to the equity
2 owner should be commensurate with returns on
3 investments in other enterprises having
4 corresponding risks. That return, moreover,
5 should be sufficient to assure confidence in
6 the financial integrity of the enterprise, so
7 as to maintain its credit and to attract
8 capital. (Citations omitted.)

9 The Supreme Court decisions in *Bluefield Water*
10 *Works* and *Hope Natural Gas* have been affirmed in *In re*
11 *Permian Basin Area Rate Case*, 390 U.S. 747, 88 S.Ct 1344,
12 20 L.Ed 2d 312 (1968), and *Duquesne Light Co. v. Barasch*,
13 488 U. S. 299, 109 S.Ct. 609, 102 L.Ed.2d. 646 (1989).
14 The Idaho Supreme Court has also adopted the principles
15 established in *Bluefield Water Works* and *Hope Natural*
16 *Gas*. See *In re Mountain States Tel. & Tel. Co.* 76 Idaho
17 474, 284 P.2d 681 (1955); *General Telephone Co. v. IPUC*,
18 109 Idaho 942, 712 P.2d 643 1986); *Hayden Pines Water*
19 *Company v. IPUC*, 122 Idaho 356, 834 P.2d 873 (1992).

20 As a result of these United States and Idaho
21 Supreme Court decisions, three standards have evolved for
22 determining a fair and reasonable rate of return:

23 (1) The Financial Integrity or Credit Maintenance
24 Standard; (2) the Capital Attraction Standard; and,
25 (3) The Comparable Earnings Standard. If the Comparable
Earnings Standard is met, the Financial Integrity or
Credit Maintenance Standard and the Capital Attraction
Standard will also be met, as they are an integral part

1 of the Comparable Earnings Standard.

2 Q. Have you considered these standards in your
3 recommendation?

4 A. Yes. These criteria have been thoroughly
5 considered in the analysis upon which my recommendations
6 are based. It is also important to recognize that the
7 fair rate of return that allows the utility company to
8 maintain its financial integrity and to attract capital
9 is established assuming efficient and economic
10 management, as specified by the Supreme Court in
11 *Bluefield Water Works*.

12 Q. Why is the return on equity calculation
13 important?

14 A. The return on equity and the overall rate of
15 return provides the method for calculating the return
16 authorized. This return provides the level of
17 compensation to investors for the use of the capital
18 invested in the utility plant and equipment to serve
19 customers. The actual return investors receive is
20 derived from dividends and growth in stock price when the
21 shares are sold. Since the direct required return is not
22 a contractual calculation, the authorized return on
23 equity serves as the proxy.

24 Q. What approach have you used to determine the
25 cost of equity for Avista?

1 A. I have primarily evaluated two methods: the
2 Discounted Cash Flow (DCF) method and the Comparable
3 Earnings method.

4 Q. Please explain the Comparable Earnings method
5 and how the cost of equity is determined using this
6 approach.

7 A. The Comparable Earnings method for determining
8 the cost of equity is based upon the premise that a given
9 investment should earn its opportunity costs. In
10 competitive markets, if the return earned by a firm is
11 not equal to the return being earned on other investments
12 of similar risk, the flow of funds will be toward those
13 investments earning the higher returns. Therefore, for a
14 utility to be competitive in the financial markets, it
15 should be allowed to earn a return on equity equal to the
16 average return earned by other firms of similar risk.
17 The Comparable Earnings approach is supported by the
18 *Bluefield Water Works* and *Hope Natural Gas* decisions as a
19 basis for determining those average returns.

20 Industrial returns tend to fluctuate with
21 business cycles, increasing as the economy improves and
22 decreasing as the economy declines. Utility returns are
23 not as sensitive to fluctuations in the business cycle
24 because the demand for utility services generally tends
25 to be more stable and predictable. However, returns have

1 fluctuated since 2000 when prices in the electricity
2 markets dramatically increased. Electricity prices have
3 not seen the dramatic spikes lately so earnings are more
4 stable.

5 Q. Please evaluate interest rate trends.

6 A. The prime interest rate has decreased in the
7 last year and half from 7.75% to the current rate of
8 3.25%. The federal funds rate and other rates have also
9 decreased this year.

10 Q. Please provide the current index levels for the
11 Dow Jones Industrial Average and the Dow Jones Utility
12 Average.

13 A. The Dow Jones Industrial Average (DJIA) closed
14 at 8404.04 on May 28, 2008. The DJIA all-time high of
15 14,000 was reached on July 19, 2007. The Dow Jones
16 Utility Average closed at 338.40 on May 28, 2008. The 52-
17 week high was 529.43 for the Dow Jones Utility Average.

18 Q. Please explain the risk differentials between
19 industrials and utilities.

20 A. Risk is a degree of uncertainty relative to a
21 company. The lower risk level associated with utilities
22 is attributable to many factors even though the
23 difference is not as great as it used to be. Utilities
24 continue to have limited competition for distribution of
25 utility services within the certificated area. With

1 limited competition for regulated services, there is less
2 chance of losses related to pricing practices, marketing
3 strategy and advertising policies. The competitive risks
4 for electric utilities have changed with increasing non-
5 utility generation, deregulation in some states, open
6 transmission access, and changes in electricity markets.
7 However, competitive risks are limited for Avista utility
8 operations. The demand for electric utility services is
9 relatively stable and certain or increasing compared to
10 that of unregulated firms and even other utility
11 industries.

12 Competitive risks continue to be average for
13 Avista than for many other electric companies primarily
14 because of the low-cost source of power, the low retail
15 rates compared to national averages, and the PCA. The
16 risk differential between Avista and other electric
17 utilities is based on the resource mix and the cost of
18 those resources. All resource mixes have risks specific
19 to resources chosen.

20 Under regulation, utilities are generally
21 allowed to recover through rates, reasonable, prudent and
22 justifiable cost expenditures related to regulated
23 services. Unregulated firms have no such assurance.
24 Utilities in general are sheltered by regulation for
25 reasonable cost recovery risks, even if it isn't 100%,

1 making the average utility less risky than the average
2 unregulated industrial firm.

3 As everyone is aware, current market trends and
4 earnings levels have dramatically declined. I believe
5 Avista continues to be in a better position than many to
6 fund its near-term capital requirements with its current
7 debt authority. The current credit and investment
8 markets are making capitalization more difficult for all.
9 In my opinion, as investors reevaluate their investment
10 portfolios, utility stocks with the primary operation
11 being the utility will be favored over higher risk
12 operations.

13 Nationally the electric utility industry has
14 seen common equity ratios decline from 46% at 12/31/2006
15 to 45% at 12/31/2007 and 44% at 6/30/2008. This means
16 long-term debt ratios increased over the respective time
17 periods; 54%, 55% and 56%. Company witness Avera, Exhibit
18 No. 3 shows similar historical averages with 46.3% equity
19 and 52.5% debt. Company witness Thies shows projected
20 ratios of 52.89% equity and 47.11% debt at June 30, 2009
21 (Thies workpaper page 1). This is better than the
22 average utility common equity ratios. The capital
23 structure recommended for Avista is 50% common equity and
24 50% long-term debt. The recommended and actual equity
25 ratios for Avista are better than the national average,

1 historical and projected, reflecting lower risk in this
2 category for Avista.

3 Authorized returns by State Commissions for
4 electric utilities during 2007 and the First Quarter of
5 2008 range from 9.1% in New York to 11.25% in Georgia.
6 During this period, 25 states decided cases authorizing
7 rates of return on equity. Many of the decisions, 14 out
8 of 25 or 56%, authorized a return on equity between 9.5%
9 and 10.5%.

10 Considering all of these comparisons, I believe
11 a reasonable return on equity attributed to Avista is
12 9.5% - 10.75% under the Comparable Earnings method.

13 Q. You indicated that the Discounted Cash Flow
14 method is utilized in your analysis. Please explain this
15 method.

16 A. The Discounted Cash Flow (DCF) method is based
17 upon the theory that (1) stocks are bought for the income
18 they provide (i.e., both dividends and/or gains from the
19 sale of the stock), and (2) the market price of stocks
20 equals the discounted value of all future incomes. The
21 discount rate, or cost of equity, equates the present
22 value of the stream of income to the current market price
23 of the stock. The formula to accomplish this goal is:
24
25

1

$$P_o = PV = \frac{D_1}{(1+k_s)^1} + \frac{D_2}{(1+k_s)^2} + \dots + \frac{D_N}{(1+k_s)^N} + \frac{P_N}{(1+k_s)^N}$$

2

3 P_o = Current Price

4 D = Dividend

5 k_s = Capitalization Rate, Discount Rate, or Required
6 Rate of Return

7 N = Latest Year Considered

8 The pattern of the future income stream is the
9 key factor that must be estimated in this approach. Some
10 simplifying assumptions for ratemaking purposes can be
11 made without sacrificing the validity of the results.
12 Two such assumptions are: (1) dividends per share grow
13 at a constant rate in perpetuity and (2) prices track
14 earnings. These assumptions lead to the simplified DCF
15 formula, where the required return is the dividend yield
16 plus the growth rate (g):

17

$$k_s = \frac{D}{P_o} + g$$

18

19 Q. Have you factored flotation costs in with your
20 cost of capital analysis?

21 A. Yes, I have considered direct flotation costs
22 in my analysis by increasing the dividend yield component
23 of the DCF analysis. Because only direct costs should be
24 considered, I have used a flotation factor of 2% assigned
25 to the utility operations. This practice continues to be

1 reasonable with recent issuances and expected near-term
2 issuances placed through the Company's Investment Plans
3 where the actual flotation costs are substantially lower
4 than direct market issuances. I have therefore adjusted
5 the DCF formula to include the direct flotation costs as
6 "df".

$$7 \quad k_s = \left[\frac{D}{P_0} (1 + df) \right] + g$$

9 Q. What is your estimate of the current cost of
10 capital for Avista using the Discounted Cash Flow method?

11 A. The current cost of equity capital for Avista
12 using the Discounted Cash Flow method is between
13 8.67% - 10.37%. The low range of 8.67% is calculated
14 using an analyst low stock price of \$20 and the growth
15 rate of 5%.

$$16 \quad [(\$0.72/\$20)1.02] + 5\%$$

17 The high range of 10.37% is calculated using the stock
18 price of \$20 and a growth rate of 6.7%.

$$19 \quad [(\$0.72/\$20)1.02] + 6.7\%$$

20 Due to ongoing capital requirements, I believe a dividend
21 yield of 3.67% with an average growth rate of 5.25% is
22 reasonable and representative resulting in a DCF return
23 on equity of 8.92%.

24 Q. How is the growth rate (g) determined?

25 A. The growth rate is the factor that requires the

1 most extensive analysis in the DCF method. It is
2 important that the growth rate used in the model be
3 consistent with the dividend yield so that investor
4 expectations are accurately reflected and the growth rate
5 is not too large or too small.

6 I have used an expected growth rate of
7 5% - 6.7%. This expected growth rate was derived from an
8 analysis of various historical and projected growth
9 indicators, including growth in earnings per share,
10 growth in cash dividends per share, growth in book value
11 per share, growth in cash flow and the sustainable
12 growth.

13 Q. What are the costs related to the capital
14 structure for debt?

15 A. I accept the cost of debt of 6.6% as
16 recommended by Company witness Thies and shown on Staff
17 Exhibit No. 119, Schedule 1.

18 Q. What capital structure has Staff used for
19 Avista to determine the overall cost of capital?

20 A. Staff Exhibit No. 119, Schedule 2, shows the
21 capital structure, debt cost utilized and the overall
22 rate of return. Staff has accepted the Company proposed
23 capital structure of 50% equity and 50% debt as shown on
24 Company witness Theis Exhibit No. 2, Schedule 2. These
25 ratios are reasonable in this case to calculate the

1 overall rate of return.

2 Q. You indicated the cost of common equity range
3 for Avista is 9.5% - 10.75% under the Comparable Earnings
4 method and 8.67% - 10.37% under the Discounted Cash Flow
5 method. What is the cost of common equity capital you
6 are recommending?

7 A. The fair and reasonable cost of common equity
8 capital I am recommending for Avista is in the range of
9 9.5% - 10.5%. Although any point within this range is
10 reasonable, the return on equity granted would not
11 normally be at either extreme of the fair and reasonable
12 range. I utilized a point estimate of 10.5% in
13 calculating the overall rate of return for the revenue
14 requirement.

15 Q. What is the basis for your point estimate being
16 10.5% when your range is 9.5% - 10.5%?

17 A. The 10.5% return on equity point estimate
18 utilized is based on a review of market data and
19 comparables, average risk characteristics for Avista,
20 operating characteristics, the capital structure, and the
21 recently authorized return on equity of 10.5% granted
22 Idaho Power by this Commission. A point above the
23 midpoint recognized the requirement for system capital
24 investments to serve customers.

25 Q. How does your recommended return compare to the

1 authorized returns for Avista?

2 A. Avista is currently authorized a 10.2% return
3 on equity and an 8.45% overall rate of return in Idaho.
4 Avista is also currently authorized a 10.2% return on
5 equity and an 8.22% overall rate of return in Washington.
6 Staff's recommended returns are higher than currently
7 authorized so will continue to support the ongoing
8 capital investments.

9 Q. What is the overall weighted cost of capital
10 recommended for Avista?

11 A. The overall weighted cost of capital
12 recommended by Staff is in the range of 8.05% - 8.55%.
13 For use in calculating the revenue requirement, a point
14 estimate consisting of a return on equity of 10.5% and a
15 resulting overall rate of return of 8.55% was utilized as
16 shown on Schedule 2, Staff Exhibit No. 119.

17 Q. Does this conclude your direct testimony in
18 this proceeding?

19 A. Yes, it does.
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21
22
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25

Line No.	Description (e)	Coupon Rate (b)	Maturity Date (c)	Settlement Date (d)	Principal Amount (e)	Issuance Costs (f)	Redemption Costs (g)	Net Proceeds (h)	Yield to Maturity (i)	Principal Outstanding 06-30-2009 (j)	Effective Cost (k)	Line No.
1	SMTN Series A	Series Costs A	08-31-2010	05-01-1983	5,000,000	373,693	690,484	4,274,465	8.275%	5,000,000	21,663	1
2	SMTN Series A	6.67%	07-12-2010	07-12-1993	7,000,000	35,081		6,945,636	7.244%	7,000,000	413,765	2
3	SMTN Series A	7.18%	08-11-2023	08-12-1993	7,000,000	54,364		6,945,636	9.455%	7,000,000	507,064	3
4	SMTN Series A	7.37%	05-10-2012	05-10-1983	7,000,000	49,114	1,227,883	5,723,003	9.287%	7,000,000	661,877	4
5	SMTN Series A	7.39%	05-11-2018	05-11-1983	7,000,000	54,364	1,227,883	5,717,753	8.953%	7,000,000	650,114	5
6	SMTN Series A	7.45%	06-11-2018	06-09-1983	15,500,000	170,597	2,140,440	13,188,963	9.359%	15,500,000	1,387,715	6
7	SMTN Series A	7.53%	05-05-2023	05-08-1983	5,500,000	42,712	963,011	4,494,277	9.375%	5,500,000	514,744	7
8	SMTN Series A	7.54%	05-05-2023	05-07-1983	1,000,000	7,766	175,412	816,822	6.982%	1,000,000	93,747	8
9	SMTN Series B	6.90%	07-01-2010	06-09-1995	5,000,000	37,944		4,962,056	6.120%	5,000,000	349,077	9
10	5.70% FMB's	5.70%	07-01-2037	12-15-2006	150,000,000	8,662,304	815,824	141,337,696	6.703%	150,000,000	9,179,874	10
11	6.125% FMB's	6.13%	09-01-2013	09-08-2003	45,000,000	1,055,140		43,129,036	5.608%	45,000,000	3,016,248	11
12	5.45% FMB's	5.45%	12-01-2019	11-18-2004	90,000,000	1,432,081		88,567,919	6.143%	90,000,000	5,047,001	12
13	6.25% FMB's	6.25%	12-01-2035	11-17-2005	150,000,000	-2,192,918		152,192,918	7.034%	150,000,000	9,213,798	13
14	5.95% FMB's	5.95%	06-01-2018	04-02-2008	250,000,000	19,475,000		230,525,000	7.575%	250,000,000	17,585,144	14
15	7.25% FMB's	7.25%	12-16-2013	12-16-2008	30,000,000	400,000		29,600,000	6.523%	30,000,000	2,272,593	15
16	PCB's Kaitie Falls	6.00%	12-01-2023	07-29-1983	4,100,000	135,855	148,383	3,817,752	6.509%	4,100,000	287,441	16
17	PCB's Series 1999A	6.75%	10-01-2032	03-31-2006	66,700,000	1,334,000	7,465,134	57,899,866		66,700,000	5,338,654	17
18	MTN's Series C	Series Costs C	06-15-2013	06-15-1988	25,000,000	650,179		24,653,047	6.475%	25,000,000	1,618,863	18
19	MTN's Series C	6.37%	06-15-2028	06-15-1988	25,000,000	158,304	188,649	24,131,186	6.515%	25,000,000	2,128,207	19
20	MTN's Series C	8.02%	10-26-2010	10-26-1999	25,000,000	161,287	707,527	841,977,365	6.788%	888,800,000	60,311,037	20
22	Repurchase	1	12-31-2017	06-30-2006	6,875,000		483,582	6,391,418	8.721%		66,586	22
23	Repurchase	1	06-30-2015	06-30-2005	26,000,000		1,735,796	24,264,204	9.208%		257,559	23
24	Repurchase	1	06-30-2014	06-30-2004	36,590,000		7,358,680	29,231,320	11.903%		1,297,205	24
25	Repurchase	1	09-30-2012	06-30-2003	52,486,000		2,819,860	49,665,140	9.564%		481,179	25
26	Repurchase	1	09-30-2010	06-30-2002	203,590,000		9,958,782	193,631,218			1,841,480	26
27											3,944,009	27
28												28
29												29
30												30
31												31
32												32
33												33
TOTAL PRO FORMA COST OF DEBT 6/30/2009												
30	3 Var. Rate Long-Term Debt				40,000,000	1,296,086	-2,500,000	41,203,914	3.172%	40,000,000	1,268,830	30
31	3 Var. Rate Long-Term Debt				17,000,000	340,000	2,332,632	14,327,368	4.768%	17,000,000	810,268	31
32												32
33												33

1 The coupon rate used is the cost of debt at the time of the repurchases
 2 The amounts are calculated using the IRR function
 3 Information pulls from the -Var. Rate Long-Term tab
 4 Forecasted issuances

AVISTA CORPORATION
Capital Structure and Overall Rate of Return

PRO FORMA Cost of Capital	<u>Percent of</u> <u>Total Capital</u>	<u>Cost</u>	<u>Component</u>
Total Debt	50.00%	6.60%	3.30%
Common Equity	<u>50.00%</u>	10.50%	<u>5.25%</u>
TOTAL	<u>100.00%</u>		8.55%

CERTIFICATE OF SERVICE

I HEREBY CERTIFY THAT I HAVE THIS 29TH DAY OF MAY 2009, SERVED THE FOREGOING **DIRECT TESTIMONY OF TERRI CARLOCK**, IN CASE NOS. AVU-E-09-1 & AVU-G-09-1, BY ELECTRONIC MAIL TO THE FOLLOWING:

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