Exhibit No. ___ T (DPK-1T)
Docket UE-090134/UG-090135
and UG-060518 (consolidated)
Witness: Danny P. Kermode
REVISED

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **AVISTA CORPORATION, d/b/a AVISTA UTILITIES,** **Respondent.**	)	**DOCKETS UE-090134 and UG-090135** ***(consolidated)***
In the Matter of the Petition of **AVISTA CORPORATION, d/b/a AVISTA UTILITIES,** **For an Order Authorizing Implementation of a Natural Gas Decoupling Mechanism and to Record Accounting Entries Associated With the Mechanism.**	)	**DOCKET UG-060518** **(*consolidated*)**

REVISED TESTIMONY

OF

DANNY P. KERMODE

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

September 2, 2009

CONTENTS

Q. Is the Company proposed adjustment consistent with the purpose of the Production Property Adjustment you described above?

A. No. The Production Property adjustment proposed by the Company fails to match properly pro forma plant additions and production related expenses with the test year, recognizing future load. In addition, the Company's adjustment does not include production related test year expenses or assets, but instead the Company's calculation uses only pro forma plant and expense adjustments.

In addition, the Company proposes using two load factors. One load factor is for the pro forma year (the year following the test year) and another load factor is for the rate year. The splitting of pro forma additions between two factors does not provide a matching of costs with rate year loads when rates will be in effect. The Production Property methodology proposed by the Company should be rejected since it fails to recognize test year production rate base and expenses and fails to match selected pro forma adjustments to the rate year load.

F. Capital Additions

Q. Please discuss the Company's adjustments for Capital Additions.

A. In its proposed capital additions adjustments, the Company initially pro forms an adjustment (PF-6 electric and PF4 gas) to its electric and gas plant-in-service amounts.[4] These initial capital additions adjustments adjust rate base in two ways: (1) pro forms

[4] PF-6 Electric, PF4 Gas.

additional plant- in- service three months outside the September 30, 2008, test-year end and (2) annualizes plant-in-service balances to a December 31, 2008, end-of-period balance. The remaining three capital additions adjustments for electric and gas operations recognize post test-year plant additions for 2009 and for the electric operations, 2010.[5] The proposed adjustments add an additional $148 million of plant to the Company's electric rate base and $12.8 million to its gas rate base. These adjustments represent a 9.2% increase in total plant in service for the electric rate base and a 4.7% increase in total plant in service for the gas rate base.

Q. Does the Company identify specific projects for their proposed pro forma additions to rate base?

A. Yes, Mr. Dave DeFelice lists over 70 projects for its 2009 capital additions pro forma adjustment.[6] In Mr. DeFelice's supporting work papers, he lists over 230 individual projects for support of his proposed 2009 adjustment.[7] In addition, Mr. Scott Kinney also lists $9.18 million of specific projects in his testimony.

Q. Please briefly discuss your understanding of the regulatory principle supporting the Company's pro forma adjustments.

---

[5] PF-7 and PF-8 Electric, PF-5 Gas.
[6] *Id*, pages 10-17.
[7] Workpapers of Dave. B. DeFelice, pages 43-54.

A. In support of its adjustments, Company witness Mr. DeFelice argues that the plant will be…"…'known and measurable' prior to the time that rates go into effect…."[8]

Q. Please describe your understanding of the Company's purpose in proposing the pro forma post test-year adjustments.

A. The Company's position is that the adjustments are required because capital costs are growing faster than recovery through embedded depreciation expense.[9] This type of dynamic is often the result of an aggressive infrastructure growth and/or replacement program. In addition, both Mr. Mark Thies and Mr. William Avera discuss the negative effects of regulatory lag and the risk of the failure to recover capital investment. Mr. Thies states that investors and rating agencies are concerned about regulatory lag and cost recovery related to these items.[10] Mr. William Avera states in his filed testimony, "Of particular concern to investors is the impact of regulatory lag and cost-recovery on Avista's ability to earn its authorized ROE and maintain its financial metrics…"[11]

Q. Is there a regulatory term for this kind of erosion of investment?

A. Yes, regulation uses the term attrition. Attrition is the tendency of a utility's rate of return to diminish over time, either because of inflationary pressures or when capital investment is not in balance with capital recovery.

---

[8] Testimony of Dave B. DeFelice, Exhibit No. ___(DBD-1T), page 2, lines 14-15.
[9] *Id*, page 7, lines 4-6.
[10] Testimony of Mark Thies, Exhibit No.___ (MTT-1T), page 21, lines 5-6.
[11] Testimony of William E. Avera, Exhibit No.___ (WEA-1T), page 47, lines 20-21.

Q. Did you review prior Commission decisions to aid you in your review of the Company's proposed adjustments?

A. Yes. Staff took note of prior Commission orders for guidance in its review of Avista's proposal. For example, in a recent Puget Sound Energy decision, the Commission discussed attrition in the context of capital investment. In that order the Commission clearly states that extraordinary circumstances are required to depart from fundamental ratemaking principles.[12] In addition, in the same order, the Commission denies out-of-period adjustments since there was "scant basis upon which to determine … to what extent they may be used and useful."[13] Finally, in a 2005 Avista order, regarding the pro forma addition to rate base of an adjustment entitled "Rate Base Adjustment for Coyote Springs II," the Commission stated:

> The matching principle requires that all cost-of-service components – revenue, investment, expenses and cost of capital – must be considered and evaluated at a similar point in time.[14]

These Commission decisions support the Staff recommendations regarding pro forma capital additions set forth below.

1. Capital Additions 2008 — PF-6 Electric and PF-4 Gas

Q. Please discuss the Company's adjustment for 2008 Capital Additions.

---

[12] *WUTC v. Puget Sound Energy, Inc.*, Docket UE-060266, 255 PUR4th 287, (2007), Order 08 at 18.
[13] *Id.* at 19.
[14] *WUTC v. Avista Corp.*, Dockets UE-050482, Order 5 at 111.

A. The Company's pro forma adjustments propose two major adjustments. The Company (a) abandons the average-of-monthly-average for end-of-period and (b) moves the end of the test-year plant in service to a pro forma amount as of December 31, 2008, three months after the end of the actual end-of-period.

Q. What offsetting factors are included in the Company's proposed adjustment?

A. Other than recognizing the impact on depreciation expense, deferred taxes, and property taxes, the Company has not included any offsetting factors. To properly match any revenues that may be provided in rates, a pro forma adjustment must not only identify the additional capital costs to provide service associated with the additional pro forma plant, but it must also identify and measure all offsetting factors, including any benefit or cost savings. Although the Company's proposed adjustments recognize increased costs such as deprecation and return on investment, it makes no attempt to quantify or even address possible cost savings. There is notable absence in the testimony of any discussion regarding studies of cost savings or other benefits associated with this adjustment. Without a thorough understanding of all offsetting benefits, there can be no matching of revenues with costs.

Q. Is the adjustment proposed by the Company consistent with prior ratemaking practice in the State of Washington?

A. No. The proposed adjustment departs from the average-of-monthly-averages method consistently used by the Commission to measure rate base. Only rarely in prior cases has the Commission used end-of-period rate base, and it is clearly the exception. For example, in the past the Commission has allowed the end-of-period approach to compensate for periods of high economic inflation[15] and in circumstances that involve rapid growth in infrastructure.[16] Consistent with each prior Commission decision was the reiteration of the matching principle when addressing end-of-period rate base, where revenues, expenses and customer count must be considered in matching costs and benefits with additional plant.[17] Here, Avista has failed to match revenues or costs to its proposed period end. Furthermore, the Commission has never approved an end-of-period test year that concludes three months after the end of the actual test-year results.

Q. Should the Commission accept the Company proposed adjustments PF-6 (Electric) and PF-4 (Gas), changing rate base valuation to end-of-period?

A. No. A proper pro forma adjustment must, by necessity, consider all material impacts and offsetting factors. If the adjustment does not, the adjustment should be rejected. The Company's proposed adjustments, which depart from the average-of-monthly-averages method of valuing rate base, simply provides for a wholesale inclusion of <u>all</u> plant in service and is clearly not supported. Other than deprecation, the Company did not address the corresponding changes in customer count, expenses, and revenues. PF-6 (Electric) and PF-4 (Gas) should be rejected.

---

[15] *WUTC v. Washington Natural Gas. Co.*, Cause No. U-80-111, Third Supplemental Order (September 1981)
[16] *WUTC v. Puget Sound Power and Light Company*, U-73-57, 6th Supplemental Order (October 1974)
[17] *WUTC v. American Water Resources, Inc.*, Dockets UW-980072 UW-980258, et al., consolidated (November 1998) at 18

2. Capital Additions 2009 — PF-7 Electric and PF-5 Gas

Q. Please discuss the Company's adjustment for 2009 Capital Additions.

A. The Company's pro forma adjustments pro form in the capital cost and expense of projects expected to be completed by December 31, 2009. The Company then calculates the pro forma balance of 2008 plant in service to December 31, 2009, levels, including accumulated depreciation and deferred FIT. In addition, the pro forma adjustment recognizes both pro forma depreciation expense and property tax.

Q. What offsetting factors are included in the Company's proposed adjustments?

A. As with the Company's adjustment for 2008 capital additions, other than recognizing the impact on depreciation expense, deferred taxes, and property taxes, the Company has not included any offsetting factors. To properly match any revenues that may be provided in rates, a pro forma adjustment must not only identify the additional capital costs to provide service associated with the additional pro forma plant, but it must also identify and measure all offsetting factors, including any benefit or cost savings. Although the Company's proposed adjustments recognize increased costs such as depreciation and return on investment, the Company makes no attempt to quantify or even address possible cost savings.

Q. Are all 2009 capital projects included in the Company's proposed out-of-period pro forma adjustment?

A. No. Mr. DeFelice describes in his testimony that the pro forma adjustments do not include "revenue producing projects." However, again, as with the 2008 Capital Addition testimony, there is no discussion regarding studies of cost savings or other benefits associated with this adjustment. The Company has produced Internal Rates of Return (IRR) studies that indicate that many of the projects will produce a reduction of the increase in future costs. However, the decrease in the future increase in costs is not quantified in the Company's proposed adjustment. Without a thorough understanding of all offsetting benefits, allowing benefits to be quantified for ratemaking, there can be no true matching of revenues with costs.

Q. Are these adjustments proposed by the Company consistent with prior ratemaking practice in the State of Washington?

A. No. The proposed adjustments are not consistent with prior practice of the Commission.

Q. Please describe how the proposed adjustments vary from the prior practice.

A. The proposed adjustments are not consistent with prior orders in two aspects. First, the adjustment includes 2008 vintage plant pro formed to an end of period December 31, 2009, adjusted balance, including accumulated depreciation and deferred FIT. This technique has never been used by the Commission for the computation of pro forma plant and Staff believes it should be rejected. The use of the AMA test year requires test year plant to be weighted by the average of monthly average approach. Moving 2008 vintage plant-in-service forward one year to end-of-period adjusted balances simply skews the test year plant-in-service balances and creates a definite mismatch of revenues and expenses of the test year.

Second, the adjustment is not consistent with the prior practice of the Commission because of the Company's inclusion of budgeted capital additions for 2009. Staff is not aware of the Commission ever accepting such a broad adjustment for out-of-period plant additions. Avista's pro forma of 2009 budgeted utility plant that was not used in the test period both violates the matching principle, is not known and measurable, and creates a mismatch of revenues, expenses, and services.

Q. Should the Commission accept the Company proposed adjustments PF-7 (Electric) and PF-5 (Gas)?

A. No. As with the prior Capital Addition pro forma adjustments, a pro forma adjustment must, by necessity, consider all material impacts and off-setting factors. If a proposed adjustment does not, the adjustment should be rejected. The Company's proposed adjustments improperly pro form 2008 vintage plant to a point in time 15 months past the end of the test year. The Company then proposes the amounts be included in rate base at an end-of-period basis, completely abandoning average-of-monthly-average rate base valuation.

In addition, the use of a capital budget to pro form in plant into the rate base, even with the exclusion of revenue producing plant, violates the known and measurable standard. Furthermore, offsetting factors and costs, other than depreciation and property taxes, have not been recognized. The Company's adjustment, therefore, should be rejected.

Q. Although Staff is recommending rejection of the Company's proposed pro forma adjustments for its 2009 Capital Additions, does Staff have a proposal that is consistent with Commission decisions and ratemaking practice?

A. Yes. Staff is proposing adjustment PF-7 (Electric) for Avista's 2009 capital additions. Staff, however is not proposing any pro forma adjustment for Avista's 2009 Gas operations additions.

Q. What criteria was used by Staff to develop its proposal for the inclusion of certain out-of-period plant in rate base?

A. It must meet the standard of a pro forma adjustment set out in WAC 480-07-510(3)(iii). Any adjustment must "give effect for the test period to all known and measurable changes that are not offset by other factors."[18] In addition, all plant additions are assumed to be beneficial in some way or the project would not be done. For example, an addition to distribution plant can be for reliability purposes but, because it is used for energy distribution, there is an assumption, absent clear auditable evidence, that the project has other offsetting factors such as less service calls or shorter outages which can increase revenues.

Q. Which out-of-period test-year plant projects not having offsetting factors, could be allowed for inclusion in rate base?

---

[18] WAC 480-07-510(3)(iii).

A. Certain projects are required by laws, regulations, or directives from regulatory bodies. Required projects such as these do not necessarily have offsetting factors, other than depreciation expense and associated deferred tax benefits which can be captured in a proposed pro forma adjustment. In addition, as described in Mr. Parvinen's testimony, the Commission has allowed, on a limited basis, pro forma transmission investment related to reliability.

Q. For the adjustment to be consistent with Commission decisions, are there further requirements for including a post-test year utility plant into rate base?

A. Yes. 2009 plant that is proposed for inclusion in rate base must be adjusted to the test year, for otherwise there will be a mismatch of costs comparing test year ended September 2008 with 2009 plant. In order to match costs, the Commission has used the technique which adjusts the pro forma plant additions to the rate year adjusted balances. The plant is depreciated from its in-service date to the end of the rate year, which in this case is December 31, 2010. The matching occurs when the Production Property Adjustment (PF-2) is applied to the plant amounts adjusting the net plant, along with its associated expenses, by the ratio of test-year to rate-year load factors.

Q. Is your proposed 2009 Capital Additions adjustment consistent with the constraints you outlined above?

A. Yes.

Q. Is your proposed 2009 Capital Additions adjustment PF- 7 for Avista's electric operations consistent with the pro forma constraints you outlined above?

A. Yes.

Q. Please describe how you determined which 2009 Capital Additions to include in the proposed pro forma adjustment.

A. The pro forma adjustment reflects post test-year capital additions from October 1, 2008, to June 30, 2009. The June 30, 2009, cutoff date was selected as the latest period that costs of completed projects were available for audit. Only projects that were in service, and therefore used and useful, as of June 30, 2009, were reviewed for possible inclusion in rate base.

Staff selected transmission projects that were either required by rule or regulatory requirements, or transmission projects that were completed for system reliability, for inclusion in rate base. In addition, two system distribution projects were included: wood pole replacement and Washington Department of Transportation required infrastructure relocations.

Generation and production projects were selected because in addition to the pro forma depreciation and deferred income tax explicit in the pro forma adjustment, the other cost benefits will be captured either in the Aurora system modeling or in Avista's Energy Recovery Mechanism.

The above plant amounts were then adjusted to the rate year 2010 average of monthly averages balances, including computation of depreciation expense and related deferred taxes.

Q. What is the impact of Staff's adjustment?

A. Staff proposed adjustment increases net rate base by $21,252,000 and increases operating expenses by $921,000, reducing net operating income after taxes by $599,000. Including return on investment and increased expenses, the net effect of this adjustment increases revenue requirement by $3,930,000, a reduction of revenue requirement of $3,944,000 from the Company's proposed $7,874,000 in additional revenues.

3. Capital Additions - Noxon — PF-8 (Electric)

Q. Please discuss the Company's adjustment for Noxon Generation 2010 (PF-8).

A. The Company proposed Noxon Generation pro forma adjustment reflects the pro forma addition to rate base of the Noxon Unit #3 upgrade. The unit is expected to be in service (used and useful) in April of 2010. The Company has included the cost of the asset as a pro forma plant addition to be included in rate base.

Q. What offsetting factors are included in the Company's proposed adjustments?

A. The pro forma adjustment recognizes both pro forma depreciation expense and property tax along with the rate base effect of accumulated depreciation and deferred taxes. However, since Noxon #3 has been included as additional generation within the Aurora dispatch model, all material additional offsetting factors have been captured in the power supply adjustment.

Q. Can budgeted post test-year plant additions be included in rate base?

A. It is rare that plant that is not complete and used and useful will be included in rate base. However, the Commission has allowed inclusion in rate base of plant that will be used and useful during the rate year. There must be a reasonable expectation that the plant will be complete and the costs are prudent. It is Staff's opinion that the plant will be completed as scheduled and that the Noxon #3 upgrade was prudent.

Q. Does Staff accept the Company adjustment for the Noxon #3 upgrade?

A. Yes, with modifications. The Company had included in its 2009 pro forma adjustment (PF-7) the Noxon #1 upgrade which was completed April 2009. Since both Noxon #1 and Noxon #3 are similar upgrade projects, both of which were included in the Aurora dispatch model, Staff did not include Noxon #1 project in PF-7 (which represented various unrelated projects). Instead, Staff has included both projects in PF-8. Staff also adjusted Noxon #3 for the fact that it will be used and useful for only nine months of the rate year. Therefore, the invested cost was weighted so that recovery will be equal to nine months consistent and matched to the benefits measured in the pro forma power cost adjustment.

Q. What is the impact of Staff's pro forma adjustment for the Noxon upgrade projects?

A. Staff's proposed adjustment increases net rate base by $13,999,000 and increases operating expenses by $156,000, or reduces net operating income after taxes by $101,000. Including return on investment and increased expenses, the net effect of this adjustment increases revenue requirement by $2,117,000, a increase of revenue requirement of $1,114,000 from the Company proposed $1,003,000 due to the addition of Noxon #1.

G. Asset Management — PF-9 (Electric) PF-6 (Gas)

Q. Please discuss the Company's adjustment for Asset Management.

A. Avista's Asset Management program manages key assets of its transmission and distribution system. The Asset Management program uses a comprehensive "Asset Management Model" to evaluate assets and for the development of an asset management plan.[19] Using projections of a future costs, the Company's PF-9 (electric) increases Washington's electric operations test year expenses by $2.9 million decreasing net operating income by $1.9 million. Whereas, PF-6 (gas) increases Washington's gas operations test year expenses by $88,000, decreasing net operating income by $57,000.

Q. Does the Company's adjustment conform to the definition of a pro forma adjustment as set out in WAC 480-09-330(2)(b)(ii)?

A. No. The adjustment does not represent an adjustment for known and measurable changes in the test year operations for either its electric or gas operations. Nor does the adjustment attempt to quantify the myriad of benefits that Mr. Scott Kinney describes in his testimony. For example, Mr. Kinney states that the Asset Management program

[19] Testimony of Scott J. Kinney, Exhibit No. ___ (SJK-1T), page 19, lines 10-19.