Exhibit No. ___(EMA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-09____________

DOCKET NO. UG-09____________

DIRECT TESTIMONY OF

ELIZABETH M. ANDREWS

REPRESENTING AVISTA CORPORATION

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I. INTRODUCTION

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

A. My name is Elizabeth M. Andrews. I am employed by Avista Corporation as Manager of Revenue Requirements in the State and Federal Regulation Department. My business address is 1411 East Mission, Spokane, Washington.

Q. Would you please describe your education and business experience?

A. I am a 1990 graduate of Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. That same year, I passed the November Certified Public Accountant exam, earning my CPA License in August 1991. I worked for Lemaster & Daniels, CPAs from 1990 to 1993, before joining the Company in August 1993. I served in various positions within the sections of the Finance Department, including General Ledger Accountant and Systems Support Analyst until 2000. In 2000, I was hired into the State and Federal Regulation Department as a Regulatory Analyst until my promotion to Manager of Revenue Requirements in early 2007. I have also attended several utility accounting, ratemaking and leadership courses.

Q. As Manager of Revenue Requirements, what are your responsibilities?

A. As Manager of Revenue Requirements, aside from special projects, I am responsible for the preparation of normalized revenue requirement and pro forma studies for the various jurisdictions in which the Company provides utility services. During the last eight and a half years I have assisted or lead the Company's electric and/or natural gas general rate filings in Washington, Idaho and Oregon.

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

A. My testimony and exhibits in this proceeding will generally cover accounting and financial data in support of the Company's need for the proposed increase in rates. I will explain pro formed operating results including expense and rate base adjustments made to actual operating results and rate base.

I incorporate the Washington share of the proposed adjustments of several witnesses in this case. For example, Company witnesses Mr. DeFelice sponsors and describes the Company's pro forma 2008 and 2009 capital additions adjustments, and Mr. Storro explains other issues impacting the Company, such as the increased generation plant capital and operating and maintenance (O&M) expenses, including the Colstrip mercury emissions O&M expense. Company witness Mr. Kinney discusses the transmission net expenses, Asset Management Program expenses, and the transmission and distribution capital expenditures included in Mr. DeFelice's pro forma capital adjustments. Lastly, Company witness Mr. Johnson prepared the total system pro forma power supply adjustment, while Ms. Knox sponsors the revenue normalization adjustment.

Q. Are you sponsoring any exhibits to be introduced in this proceeding?

A. Yes. I am sponsoring Exhibit Nos.____(EMA-2) (Electric) and ___(EMA-3) (Natural Gas), which were prepared under my direction. These Exhibits consist of worksheets, which show actual 2008 operating results (twelve-month period ending September 30, 2008), pro forma, and proposed electric and natural gas operating results and rate base for the State of Washington, the Company's calculation of the general revenue requirement, the derivation of the net operating income to gross revenue conversion factor, and the pro forma adjustments proposed in this filing.

II. COMBINED REVENUE REQUIREMENT SUMMARY

Q. Would you please summarize the results of the Company's pro forma study for both the electric and natural gas operating systems for the Washington jurisdiction?

A. Yes. After taking into account all standard Commission Basis adjustments, as well as additional pro forma and normalizing adjustments, the pro forma electric and natural gas rates of return ("ROR") for the Company's Washington jurisdictional operations are 4.37% and 6.96%, respectively. Both return levels are below the Company's requested rate of return of 8.68%. The incremental revenue requirement necessary to give the Company an opportunity to earn its requested ROR is $69,762,000 for the electric operations and $4,918,000 for the natural gas operations. The overall base electric increase associated with this request is 17.84%.[1] However, as explained by Company witness Mr. Hirschkorn, with the reduction of the Energy Recovery Mechanism (ERM) surcharge of 9% planned at the same time the general rate increase will go into effect for customers, the net impact on the residential customers' bill is anticipated to be approximately 8.84%. The base natural gas increase is 2.28%.

Q. What are the Company's rates of return that were last authorized by this Commission for it's electric and gas operations in Washington?

A. The Company's currently authorized rate of return for its Washington operations

[1] Percentages reflect the proposed increase to base tariff rates, Mr. Hirschkorn describes the effect based on present billed rates.

is 8.43 %, effective January 1, 2009 for both our electric and natural gas systems.

III. ELECTRIC SECTION

Changes Since the 2007 Test Period

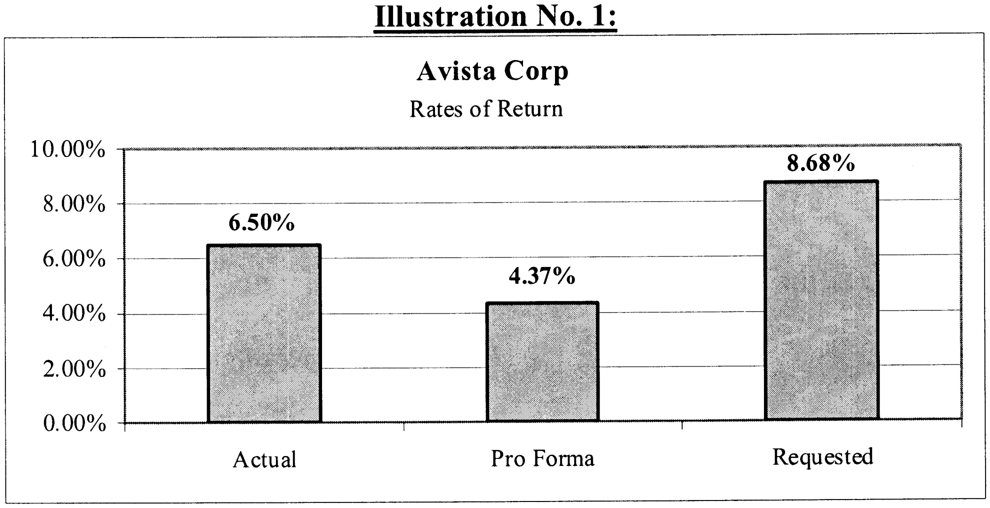
Q. On what test period is the Company basing its need for additional electric revenue?

A. The test period being used by the Company is the twelve-month period ending September 30, 2008, presented on a pro forma basis. Currently authorized rates are based upon the 2007 test year utilized in UE-080416, adjusted on a pro forma basis.

Q. By way of summary, could you please explain the different rates of return that you will be presenting in your testimony?

A. Yes. Basically, there are three different rates of return that will be discussed. The actual ROR earned by the Company during the test period, the Pro Forma ROR determined in my Exhibit No.___(EMA-2), and the requested ROR. For convenience of comparison, please refer to the following illustration:

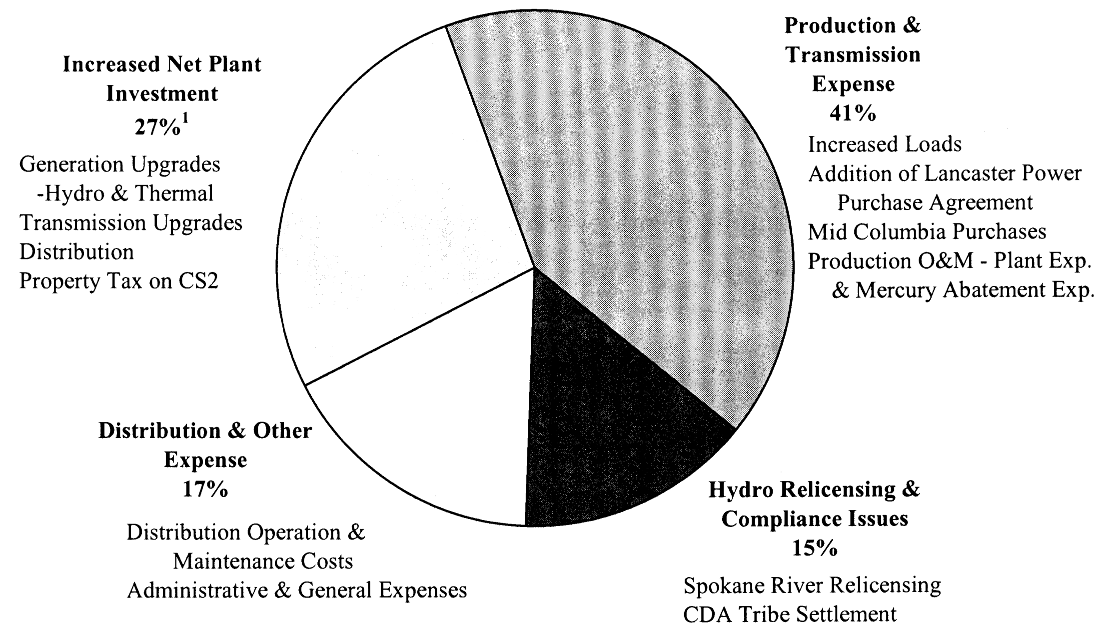
Illustration No. 1:



Q. What are the primary factors driving the Company's need for an electric increase?

A. Illustration No. 2 below, shows the primary factors driving the electric revenue requirement in this case. Additional details regarding these items are provided later in my testimony.

Illustration No. 2:
Primary Electric Revenue Requirement Factors



[1]Includes return on investment, depreciation and taxes, offset by the tax benefit of interest.

Q. Please describe the primary factors driving the Company's need for an electric increase?

A. There are numerous factors that have impacted the Company's Washington electric results of operations since the last rate case. Net Operating Income ("NOI") has declined approximately $10.2 million, or 13.2%, and total rate base has increased approximately $67.8

million, or 7.2%. The Company's electric request is driven by changes in various operating cost components as shown by Illustration No. 2 above, primarily power supply costs, plant investment or rate base growth associated with generation, transmission and distribution plant (including pro forma capital spending requirements during 2009) and by various hydro relicensing efforts impacting the Utility.

Q. Please explain each of the four components or segments shown in Illustration No. 2 above.

A. The first segment, Production and Transmission Expense increases, as explained below, comprise approximately 41% of the overall request. The next largest segment is Increased Net Plant Investment. As already noted, net rate base for the Washington jurisdiction increased approximately $67.8 million, or 7.2%, of which $30.1 million comprise of additional gross generation plant, both hydro and thermal, and transmission plant. In addition, gross distribution plant increased $80.7 million, or 41.0%. The depreciation recovery, taxes associated with plant, and the return on additional plant investment offset by the tax benefit of interest (excluding net rate base associated with hydro relicensing efforts noted below), make up approximately 27% of the overall Company request.

Additional plant investment relating to the hydro relicensing and compliance efforts pro formed into this case make up approximately 15% of the overall request, and include the intangible net rate base and expenses associated with the Spokane River relicensing and Coeur d'Alene Tribe Settlement agreement. The majority of these charges were reviewed in the company's previous general electric rate case proceeding, Docket No. UE-080416, and the Commission found these charges to be prudently incurred. The Company was allowed to defer the amortization of these charges for later recovery, including a carrying charge on the deferrals and unamortized balance, and include recovery of these costs in its next general rate case. (See Order No. 08) As explained further in my testimony, these amounts have been included for recovery in this general rate case filing.

The remaining cost category, Distribution and Other Expense, which includes increases to all other operating categories, such as distribution expenses, customer service, and administrative and general, totals approximately 17% of the overall request.

Q. Could you please provide additional details related to the charges in Production and Transmission Expenses?

A. As discussed in Mr. Johnson's testimony, the level of Washington's share of power supply expense has increased by approximately $24.4 million ($37.7 million on a system basis) from the level <u>currently in base rates</u>.

This increase in pro forma power supply expense over the expense currently in base rates is based on numerous factors, including higher retail loads, increased net power supply expense related to the addition of the Lancaster plant revenue and expenses, and the expiration of the Mid-Columbia (Wanapum) contract in November 2009.

Pro forma retail loads are 37.6 aMW higher than loads that current rates are based on. The increased loads are due to two factors. One is the natural increase in retail loads of approximately 29.2 aMW. The other 8.4 aMW of load increase is due to the reduction in Potlatch generation. Because Potlatch generation expense is directly assigned to Idaho, the Potlatch load equivalent to their generation is removed from system loads. The reduction in Potlatch generation has the effect of increasing system loads for rate making purposes.

The other primary expense increase is the addition of the Lancaster plant, from which the Company begins receiving power on January 1, 2010. The increase in pro forma net expense related to the inclusion of the Lancaster plant is approximately $16.6 million (system) or $10.7 million (Washington share). Mr. Johnson discusses these differences in detail in his testimony.

Q. Could you please identify the main components of the "Distribution & Other" segment shown in the illustration above?

A. Yes. A number of expense items have increased since 2007, which have been included in this case. For example, employee benefits such as wages, pension and medical insurance expenses have increased, as well as other administrative and general expenses such as those related to the Company's information services.

We are utilizing a twelve-month ending September 30, 2008 test year, since that is the most recent normalized financial information the Company has available; however, new general electric rates resulting from this filing are not expected to go into effect until December 2009. Accordingly, the Company has included a number of pro forma adjustments to capture some of the measurable cost changes that the Company will experience from the test year.

Q. What were the major components of the $67.8 million increase in total rate base?

A. Looking at the changes to "gross" plant in service shows that Washington gross plant increased almost $197 million, or 11.9%, as compared to what is currently included in rates. Included in this "gross" plant total is $57.8 million of pro forma capital recorded in intangible plant, mainly associated with the Spokane River relicensing and Coeur d'Alene Tribe Settlement agreement or approximately 29.4% of the total change to "gross" plant.

To continue to meet the energy and reliability needs of our customers, the Company has invested additional amounts in thermal and hydro generating facilities, as well as additional transmission investment. The total production and transmission plant investment included in this case (discussed later in my testimony) totaled approximately $30.2 million or 15.3% of the total changes to "gross" plant.

The specific pro forma capital expenditures undertaken by the Company to upgrade its generation and transmission facilities and improve operating efficiency and reliability, are discussed further by Mr. Storro regarding production assets, and Mr. Kinney regarding transmission and distribution assets. Mr. Kinney also discusses the pro forma distribution projects.

Q. What other rate base additions are included in Total Rate Base?

A. Distribution "gross" plant increased $80.7 million above the current level included in rates, while general "gross" plant increased $28.2 million or 14.1% of the total gross plant.

Later in my testimony, I will address the Spokane River relicensing and Coeur d'Alene Tribe Settlement agreement pro forma adjustments, and the additional net rate base adjustments labeled "Pro Forma Capital Additions 2008", "Pro Forma Capital Additions 2009" and "Noxon Generation 2010" included in Exhibit No.__(EMA-2), pages 8 and 9. This exhibit explains the detail behind the normalizing and pro forma net operating income and rate base adjustments.

The figures listed above are "gross" plant investment changes. Again, taking into account increases to Accumulated Depreciation and Amortization and Deferred Federal Income Tax offsets, this produces the net $67.8 million, or 7.2% increase to Total Rate Base. Depreciation expense, which has largely followed the 11.9% growth in gross plant-in-service, has increased $7.6 million.

Q. Mr. DeFelice sponsors the pro forma capital adjustments included in this case. Could you please briefly describe the conclusions drawn by Mr. DeFelice regarding the increased capital investment?

A. Yes. As described in Mr. DeFelice's testimony, the Company is making substantial levels of capital investment in its electric and natural gas system infrastructure to address customer growth, replacement and maintenance of Avista's aging system, and to provide for increased reliability and safety requirements. As soon as this new plant is placed in service, the Company must start depreciating the new plant and incur other costs related to the investment. Unless this new investment is reflected in retail rates in a timely manner, it has a negative impact on Avista's earnings, particularly because the new plant is typically far more costly to install than the cost of similar plant that was embedded in rates decades earlier. As plant is completed and is providing service to customers, it is appropriate for the Company to receive timely recovery of the costs associated with that plant.

Revenue Requirement

Q. Would you please explain what is shown in Exhibit No._____(EMA-2)?

A. Yes. Exhibit No._____(EMA-2) shows actual and pro forma electric operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No.____(EMA-2) shows 2008 actual operating results (twelve-months ended September 30, 2008) and components of the average-of-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is pro forma results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn a 8.68% rate of return. Column (f) reflects pro forma electric operating results with the requested increase of $69,762,000. The restating adjustments shown in columns *(c)* through *(y),* of pages 4 through 7 of Exhibit No._____(EMA-2), are consistent with the treatment reflected in the prior Commission Order in Docket No. UE-080416 and current regulatory principles.

Q. Would you please explain page 2 of Exhibit No._____(EMA-2)?

A. Yes. Page 2 shows the calculation of the $69,762,000 revenue requirement at the requested 8.68% rate of return.

Q. Would you now please explain page 3 of Exhibit No._____(EMA-2)?

A. Yes. Page 3 shows the derivation of the net operating income to gross revenue conversion factor. The conversion factor takes into account uncollectible accounts receivable, Commission fees and Washington State excise taxes. Federal income taxes are reflected at 35%.

Q. Now turning to pages 4 through 11 of your Exhibit No._____(EMA-2), would you please explain what those pages show?

A. Page 4 begins with actual operating results and rate base for the 2008 test period (twelve-months ended September 30, 2008) in column (b). Individual normalizing adjustments that are standard components of our annual reporting to the Commission begin in column (c) on page 4 and continue through column (y) on page 7. Individual pro forma and additional normalizing adjustments begin in column (PF1) on page 7 and continue through column (PF19) on page 11. The final column on page 11 is the total pro forma operating results and rate base for the test period.

__**Standard Commission Basis Adjustments**__

Q. Would you please explain each of these adjustments, the reason for the adjustment and its effect on test period State of Washington net operating income and/or rate base?

A. Yes, but before I begin, I will note that in addition to the explanation of adjustments provided herein, the Company has also provided workpapers outlining additional details related to each of the adjustments.

The first adjustment, column (c) on page 4, entitled **Deferred FIT Rate Base**, reflects the rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing premiums, and contributions in aid of construction. These amounts are reflected on the average of monthly average balance basis. The effect on Washington rate base is a reduction of $142,713,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for Washington's portion of the net of tax, unamortized gain on the sale of the Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period scheduled to end in 2011. This accounting treatment was approved in Order No. 01 in Docket No. U-071805. This adjustment reflects the average of monthly averages amount of the deferred gain for the 2010 rate period. The effect on Washington rate base is a reduction of $126,000.

The adjustment in column (e), **Colstrip 3 AFUDC Elimination**, is a reallocation of rate base and depreciation expense between jurisdictions. In Cause Nos. U-81-15 and U-82-10, the WUTC allowed the Company a return on a portion of Colstrip Unit 3 construction work in progress ("CWIP"). A much smaller amount of Colstrip Unit 3 CWIP was allowed in rate base in Case U-1008-144 by the Idaho Public Utilities Commission ("IPUC"). The Company eliminated the AFUDC associated with the portion of CWIP allowed in rate base in each jurisdiction. Since production facilities are allocated on the Production/Transmission formula, the allocation of AFUDC is reversed and a direct assignment is made. The rate base adjustment reflects the average of monthly averages amount for the test period. The effect on Washington net operating income is an increase of $202,000. The effect of the reallocation on Washington rate base is a decrease of $1,956,000.

The adjustment in column (f), **Colstrip Common AFUDC**, is also associated with the Colstrip plants in Montana, and increases rate base. Differing amounts of Colstrip common facilities were excluded from rate base by this Commission and the IPUC until Colstrip Unit 4 was placed in service. The Company was allowed to accrue AFUDC on the Colstrip common facilities during the time that they were excluded from rate base. It is necessary to directly assign the AFUDC because of the differing amounts of common facilities excluded from rate base by this Commission and the IPUC. In September 1988, an entry was made to comply with a Federal Energy Regulatory Commission ("FERC") Audit Exception, which transferred Colstrip common

AFUDC from the plant accounts to account 186. These amounts reflect a direct assignment of rate base for the appropriate average of monthly averages amounts of Colstrip common AFUDC to the Washington and Idaho jurisdictions. Amortization expense associated with the Colstrip common AFUDC is charged directly to the Washington and Idaho jurisdictions through Account 406 and is a component of the actual results of operations. The rate base adjustment reflects the average of monthly averages amount for the test period. The effect on Washington rate base is an increase of $436,000.

The adjustment in column (g), **Kettle Falls Disallowance**, decreases rate base. The amounts reflect the Kettle Falls generating plant disallowance ordered by this Commission in Cause No. U-83-26. The disallowed investment and related depreciation, FIT expense, accumulated depreciation and accumulated deferred FIT are removed from actual results of operations. The rate base adjustment and the accumulated deferred FIT reflects the average of monthly averages amount for the test period. The effect on Washington net operating income is a decrease of $56,000. The effect on Washington rate base is a decrease of $854,000.

The adjustment in column (h), **Customer Advances**, decreases rate base for moneys advanced by customers for line extensions, as they will most likely be recorded as contributions in aid of construction at some future time. The effect on Washington rate base is a decrease of $231,000.

Q. Please turn to page 5 and explain the adjustments shown there.

A. Page 5 starts with the adjustment in column (i), **Depreciation True-up**, which reflects a decrease in depreciation expense due to the utilization of new depreciation rates effective January 1, 2008 as approved in Docket No. UE-070804. These rates became effective after the three months (October through December 2007) included in the test period. This adjustment annualizes the current effective rates for the test period. This adjustment increases Washington net operating income by $39,000.

The adjustment in column (j), **Settlement Exchange Power,** reflects the rate base associated with the recovery of 64.1% of the Company's investment in Settlement Exchange Power. The 64.1% recovery level was approved by the Commission's second Supplemental Order in Cause No. U-86-99 dated February 24, 1987. Amortization expense and deferred FIT expense recorded during the test period are reflected in results of operations. The rate base adjustment and accumulated deferred FIT reflects the average of monthly averages amount for the 2010 rate period. The effect on Washington rate base is an increase of $18,422,000.

The next column marked by a dash, entitled **Subtotal Actual** represents actual operating results and rate base plus the standard rate base adjustments that are included in Commission Basis reporting.

The adjustment in column (k), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated with local business and occupation (B & O) taxes, which the Company is allowed to pass through to its Washington customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $22,000.

The adjustment in column (l), **Property Tax**, restates the test period accrued levels of property taxes to the most current information available and eliminates any adjustments related to the prior year. This adjustment includes the increase in property taxes in 2009, related to the Company's Coyote Springs plant located in Oregon. Previously the Company had been excluded from this property tax assessment for five years under a tax abatement as a result of the plant being located in the Columbia River Enterprise Zone in Oregon. The effect of this particular adjustment is to decrease Washington net operating income by $939,000.

The adjustment in column (m), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to increase Washington net operating income by $70,000.

The adjustment in column (n), **Regulatory Expense**, restates recorded 2008 regulatory expense to reflect the WUTC assessment rates applied to revenues for the test period and the actual levels of FERC fees paid during the test period. The effect of this adjustment is to decrease Washington net operating income by $52,000.

Q. Please turn to page 6 and explain the adjustments shown there.

A. The adjustment in column (o), **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to decrease Washington net operating income by $56,000.

The adjustment in column (p), **FIT**, adjusts the FIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items, matching the jurisdictional allocation of other Schedule M items to related Results of Operations allocations and to adjust the appropriate level of production tax credits for pro forma qualified generation. The FIT adjustment decreases Washington net operating income by $1,715,000. This adjustment also reflects the proper level of deferred tax expense for the test period decreasing Washington net operating income by $36,000. Therefore, the net effect of this adjustment all based upon a Federal tax rate of 35% is to decrease Washington net operating income by $1,751,000.

The adjustment in column (q), **Eliminate WA ERM Surcharge & Deferrals**, removes the effects of the financial accounting for the Energy Recovery Mechanism (ERM.) The ERM normalizes and defers certain net power supply and transmission revenues and costs pursuant to the deferral and recovery mechanism authorized in Docket No. UE-070804. The adjustment removes the ERM surcharge revenue as well as the deferral and amortization amounts and certain directly assigned power costs and net transmission costs associated with the ERM. The effect of this adjustment is to decrease Washington net operating income by $8,844,000.

The adjustment in column (r), **Nez Perce Settlement Adjustment**, reflects an increase in Production operating expenses. An agreement was entered into between the Company and the Nez Perce Tribe to settle certain issues regarding earlier owned and operated hydroelectric generating facilities of the Company. This adjustment directly assigns the Nez Perce Settlement expenses to the Washington and Idaho jurisdictions. This is necessary due to differing regulatory treatment in Idaho Case No. WWP-E-98-11 and Washington Docket No. UE-991606. This restating adjustment is consistent with Docket No. UE-011595. The effect of this adjustment is to decrease Washington net operating income by $6,000.

The adjustment in column (s), **Eliminate A/R Expenses**, A/R representing Accounts Receivable, removes expenses associated with the sale of customer accounts receivable. The effect of this adjustment is to increase Washington net operating income by $335,000.

The adjustment in column (t), **Office Space Charged to Subs**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T and is consistent with Docket No. UE-080416. The effect of this adjustment is to increase Washington net operating income by $5,000.

The adjustment in column (u), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to decrease Washington net operating income by $20,000.

Q. Please continue on page 7 with your explanation of the adjustments.

A. The adjustment in column (v), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 1999 and 2008. This restating adjustment is made as a result of the Commission's Order in Docket No. UE-050842 and is consistent with Docket No. UE-080416. The effect of this adjustment is to increase Washington net operating income by $79,000.

The adjustment in column (w), **Revenue Normalization**, is a 3-fold adjustment taking into account known and measurable changes that include revenue repricing (including the current authorized rates approved in Docket No. UE-080416), weather normalization and a recalculation of unbilled revenue. Revenues associated with the Schedule 91 Tariff Rider and Schedule 59 Residential Exchange are excluded from pro forma revenues, and the related amortization expense is eliminated as well. Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $23,394,000.

The adjustment in column (x), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, sponsorships and dues and donations included in error in the test period actual results. The effect of this adjustment is to increase Washington net operating income by $139,000.

The adjustment in column (y), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Company witness Mr. Thies, and applied to Washington's pro forma level of rate base, produces a pro forma level of tax deductible interest expense. The Federal income tax effect of the restated level of interest for the test period increases Washington net operating income by $683,000.

Q. Please continue on page 7 with your explanation of the adjustments.

A. Column (z), on page 7, entitled **Restated Total**, subtotals all the preceding columns (b) through column (y), exclusive of the previously discussed subtotal column. These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports except power supply[2].

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[2] The restated total also includes the additional property tax on CS2 required starting in 2009 included in the property tax restating adjustment column (l).

Pro Forma Adjustments

Q. Please explain the significance of the 19 columns subsequent to column (z) that begins at page 7 in your Exhibit No.____(EMA-2).

A. Certainly. The adjustments subsequent to column (z) are pro forma adjustments that recognize the jurisdictional impacts of items that will impact the pro forma operating period levels for known and measurable changes. They encompass revenue and expense items as well as additional capital projects. These adjustments bring the operating results and rate base to the final pro forma level for the rate year.

Q. Please continue with your explanation of the adjustments starting on page 7, subsequent to column (z).

A. The adjustment in column (PF1), **Pro Forma Power Supply**, was made under the direction of Mr. Johnson and is explained in detail in his testimony. This adjustment includes pro forma power supply related revenue and expenses to reflect the twelve-month period January 1, 2010 through December 31, 2010. Mr. Johnson's testimony outlines the system level of pro forma power supply details that are included in this adjustment. This adjustment calculates the Washington jurisdictional share of those figures, and also eliminates an offsetting direct assignment of certain power supply costs included in the base Results of Operations. The net effect of the power supply adjustments decreases Washington net operating income by $24,030,000.

Q. Please turn to page 8 and explain the adjustments shown there.

A. The adjustment in column (PF2), **Pro Forma Production Property Adjustment,** adjusts pro formed production and transmission revenues, expenses, and rate base by a factor that reflects the ratio of 2008 Washington test year retail load divided by the pro forma period Washington retail load. Capital additions have been pro formed to December 2009 whereas the remainder of the pro forma adjustments reflect costs for the twelve months ended December 2010 level. Therefore a factor reflecting 2009 calendar Washington retail load was used to determine the factor for pro formed capital costs and the 2010 rate year Washington retail load was used to determine the factor for all other pro formed production and transmission costs. The adjustment is made to avoid the over-recovery of pro formed production and transmission costs, since the revenue requirement associated with those costs is being spread to test year retail load. The use of a production property adjustment in conjunction with pro forma rate year loads for power supply results in a better matching of revenues and expenses during the period that new retail rates from the case will be in effect. The effect of this adjustment on Washington net operating income is an increase of $6,449,000. The effect on Washington rate base is a decrease of $12,500,000.

The adjustment in column (PF3), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in PF4. Test period wages and salaries are restated as if the wage and salary increases through March 2010 were in place during the entire pro forma period. The methodology behind this adjustment is consistent with Docket Nos. UE-011595, UE-050842 and UE-070804. The effect of this adjustment on Washington net operating income is a decrease of $1,942,000.

The adjustment in column (PF4), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating their salaries as if wage and salary increases through March 2010 were in place for the entire pro forma test period. This adjustment takes into account changes in executive staffing made during 2008 and includes compensation for the planned executive team in 2010 only. Compensation costs for non-utility operations are excluded as executives routinely charge a portion of their time to non-utility operations, commensurate with the amount of time spent on such activities. The current executives' salary allocations are set at their expected pro forma test period utility/non-utility percentage splits. The impact of this adjustment on Washington net operating income is a decrease of $155,000.

Q. Can you please provide additional details regarding the determination of officer compensation?

A. Yes. At Avista, our compensation philosophy is founded in the belief that our success will be driven by our ability to hire, develop and retain the most competent employees. In an effort to recruit and retain such people, we provide salaries, performance incentives and benefits that are competitive in the marketplace, as benchmarked against other similarly-sized energy companies, in regional and national markets.

The Compensation Committee of the Board has responsibility for establishing, implementing, and continually monitoring adherence to the Company's compensation philosophy. The Compensation Committee believes that an effective total compensation plan should be structured to focus executives on the achievement of specific business goals set by the Company and to reward executives for achieving such goals.

The Compensation Committee compensates senior management through a mix of base salary; short-term performance-based cash incentive compensation; long-term equity incentive compensation – performance shares or restricted stock (100 percent of this compensation is paid by shareholders, and none by customers); and retirement and other benefits.

In recent years, the total compensation for Avista's executives (particularly the top five Executive Officers identified in the proxy) has been predominantly funded by Avista's shareholders. As an example, as noted above, none of the long-term equity incentive is paid by customers. In addition, the portion of the annual cash incentive that is related to meeting shareholder targets, such as earnings per share, is also not paid by customers. And finally, a portion of officer salaries is also allocated to subsidiary operations, which further reduces the total compensation paid by customers.

Q. Please continue with your explanation of the adjustments on page 8.

A. Column (PF5), **Pro Forma Transmission Rev/Exp,** was made under the direction of Mr. Kinney and is explained in detail in his testimony. This adjustment includes pro forma transmission-related revenues and expenses to reflect the twelve-month period January 1, 2010 through December 31, 2010. The net effect of the transmission revenue and expense adjustments decreases Washington net operating income by $51,000.

The adjustment in column (PF6), **Pro Forma Capital Additions 2008**, pro forms in the capital cost and expenses associated with adjusting the 2008 average-monthly-average plant related balances to actual end-of-period balances for plant in service at December 31, 2008. The capital costs have been included for December 31, 2008 pro forma period with the associated depreciation expense and property tax, as well as the appropriate accumulated depreciation and deferred income tax rate base offsets. This adjustment was made under the direction of Mr. DeFelice and is described further in his testimony. The production property adjustment is also applied to the production and transmission components of these additions as discussed above. This adjustment decreases Washington net operating income by $473,000 and increases rate base by $21,445,000.

The adjustment in column (PF7), **Pro Forma Capital Additions 2009**, pro forms in the capital cost and expenses associated with pro forming in capital expenditures for 2009. This adjustment includes projects expected to be completed and transferred to plant-in-service by December 31, 2009. The capital costs have been included for the appropriate pro forma period with the associated depreciation expense and property tax, as well as the appropriate accumulated depreciation and deferred income tax rate base offsets. This adjustment also reduces the 2008 vintage plant net rate base (including accumulated depreciation and deferred FIT) to an end of period December 31, 2009 adjusted balance. This adjustment was also made under the direction of Mr. DeFelice and is described further in his testimony. The production property adjustment is also applied to the production and transmission components of these additions as discussed above. This adjustment decreases Washington net operating income by $2,906,000 and increases rate base by $22,936,000.

Q. Please turn to page 9 and explain the adjustments shown there.

A. The adjustment in column (PF8), **Pro Forma Noxon Generation 2010,** pro forms in the Noxon capital project planned for completion in April 2010. As explained further by Mr. Storro, Noxon Unit #3 is scheduled to have a new turbine and complete mechanical overhaul between August 2009 and March 2010. This unit upgrade is planned to increase unit efficiency and boost the unit rating. Although completion of this upgrade is planned in 2010, beyond the completion date of December 31, 2009 pro formed into this case for all other capital projects, the

Company has included the additional generation from this upgrade in its Dispatch Model for the rate year, as discussed by Company witness Mr. Kalich. Since the Company has included the additional generation from this Noxon upgrade within its Dispatch Model, ultimately reducing power supply expenses for customers in the 2010 rate year, it is necessary to include this project in rate base for the rate period in order to match revenues with expenses for this project. This adjustment decreases Washington net operating income by $156,000 and increases rate base by $5,386,000.

The adjustment in column (PF9), **Pro Forma Asset Management**, pro forms in the O&M expense associated with the Asset Management Program as described further by Company witness Mr. Kinney. This adjustment decreases Washington net operating income by $1,883,000.

The adjustment in column (PF10), **Pro Forma Information Services**, pro forms in the administrative and general (A&G) expenses associated with incremental known and measureable changes for labor and non-labor informational services costs planned for 2010 above the test period. As explained by Company witness Mr. Kopczynski, these expenditures are related to 1) additional labor dollars required to support applications utilized by the Company in recent years, such as the mobile dispatch and outage management applications, improved web application support, and additional required security and compliance requirements; and 2) additional non-labor dollars required for hosting fees, application fees, software maintenance and license fees, and new and replacement software and hardware for business applications. This adjustment decreases Washington net operating income by $1,139,000.

The adjustment in column (PF11), **Pro Forma Spokane River Relicensing**, includes the costs associated with the Company's Spokane River relicensing efforts and the CDA Tribe settlement 4(e) relicensing conditions and accrued interest as described further in my workpapers. These costs include actual life-to-date expenditures from April 2001 through December 31, 2008, and 2009 pro forma expenditures through June 30, 2009. Company witness Mr. Storro provides additional details regarding the status of the Spokane River Relicensing efforts and explains that the Company anticipates a final license approved by the Federal Energy Regulatory Commission (FERC) by June 30, 2009. The majority of these charges were reviewed in the Company's previous general electric rate case proceeding, Docket No. UE-080416, and the Commission found these charges to be prudently incurred. The Company was allowed to defer the amortization of these charges, including a carrying charge on the unamortized balance, and include recovery of these costs in its next general rate case. (See Order No. 08)

Subsequent to the conclusion of Docket No. UE-080416, and during review of the total current actual expenditures-to-date for the Spokane River Relicensing efforts, it was discovered that the Company had inadvertently failed to continue to compute and accrue AFUDC after December 31, 2004 on certain expenditures that had been recorded for the years 1999 to 2004. (In other words, AFUDC was not recorded for the period January 2005 through November 2008 on amounts spent 1999 through 2004.) This error was discovered in December 2008 and corrected, accruing an additional amount of approximately \$3.0 million. This correction caused an increase in costs included in this case, above that approved in Docket No. UE-080416, of approximately \$1.9 million (Washington share) to accrue for the missed AFUDC from January 2005 through November 2008 on the 1999 through 2004 balance. This adjustment, including the

AFUDC correction, decreases Washington net operating income by $2,363,000 and increases rate base by $23,325,000.

The adjustment in column (PF12), **Pro Forma Coeur d' Alene Tribe Settlement**, includes costs associated with the Lake Coeur d' Alene Tribe (CDA Tribe) settlement agreement. Mr. Storro describes further the final agreement between the Company and the CDA Tribe. The settlement includes the payment of $25.0 million in December 2008, $10.0 million in 2009 and $4.0 million in 2010 for resolution of the past trespass and §10(e) charges. The future §10(e) payments are $400,000 flat annual payments for the first 21 years of the new Spokane River license, starting in December 2008, of the license and $700,000 flat annual payments for the remaining years of the license. The agreed upon settlement and payments were reviewed in the Company's previous electric general rate case proceeding, Docket No. UE-080416, and the Commission found the settlement and planned payments to be prudent. As approved by the Commission's Order, the Company is allowed to defer the amortization of the initial 2008 payments, including a carrying charge on the deferrals and unamortized balance, and include recovery of these costs in its next general rate case. (See Order No. 08) These deferred payments, including a return on the balance, are planned to be amortized over the average remaining life of the Post Falls Project, or 45 years. The pro forma adjustment includes one year amortization of the deferred balance, and the 2009 annual payment of $400,000. This adjustment decreases Washington net operating income by $539,000 and increases rate base by $16,819,000.

The adjustment in column (PF13), **Pro Forma Montana Riverbed Lease**, includes costs associated with the Montana Riverbed lease settlement. In this settlement, the Company agreed to pay the State of Montana $4.0 million annually beginning in 2007, with annual inflation adjustments, for a 10-year period for leasing the riverbed under the Noxon Rapids Project and the Montana portion of the Cabinet Gorge Project. The first two annual payments were deferred by Avista as approved in Docket No. UE-072131. In Docket No. UE-080416 (see Order No. 08), the Commission approved the Company's proposed accounting treatment of the deferred payments, including accrued interest, to be amortized over the remaining eight years of the agreement starting January 1, 2009. The pro forma adjustment includes one-eighth of the deferred balance amortization and the annual lease payment expense. This adjustment decreases Washington net operating income by $2,285,000 and increases rate base by $2,859,000.

Q. Please turn to page 10 and explain the adjustments shown there.

A. The adjustment in column (PF14), **Pro Forma Colstrip Mercury Emission O&M**, includes additional 2010 O&M costs associated with the mercury control project at Colstrip as further described by Mr. Storro. This adjustment decreases Washington net operating income by $1,217,000.

The adjustment in column (PF15), **Pro Forma Incentives**, adjusts the test year incentive expense to the 2008 incentive expense expected to be paid in 2009 for the 2008 incentive plan. The Company's main employee incentive plan uses Customer Satisfaction and Reliability targets as the initial step in issuing incentive payouts. Actual payouts are dictated by utility O&M cost savings. Since the executive plan is slightly different than the main employee incentive plan, this adjustment removes any part of the 2008 executive incentive payout that was "not" based on the Customer Satisfaction and Reliability targets. This pro forma adjustment further adjusts incentive expenses to a 6 year average. The impact of this adjustment on Washington net operating income is a decrease of $357,000.

Q. Please explain how the Company computed its 6-year average.

A. Actual incentives paid and the associated payroll taxes accrued for years 2003 through 2007 were adjusted by the Consumer Price Index (CPI) annual average for the calendar year the incentives were paid, to reflect those costs in 2008 dollars. The computed six-year average of 2003 through 2008 incentives was compared to incentive expense included in the test period to determine the pro forma adjustment.

Q. Why did the Company choose to use a 6-year average?

A. Since annual Company incentive plan payouts can often vary year-to-year, the Company has chosen to propose an average of annual pay outs. Often where there are revenues or expenses that can vary significantly from year-to-year and therefore uncertain as to the appropriate level, the Commission has utilized or approved averages to properly reflect a fair and reasonable level of revenue or expense to be included in customers' rates. In 2002 the Company changed its incentive plan to be based on Customer Satisfaction and Reliability targets, and the requirement that O&M savings must occur in order for there to be any pay out. This is significantly different than the plans prior to 2002 based on earnings targets of the Company. Utilizing a 6-year average, using years 2003 through 2008, includes common incentive plans that are comparable from year-to-year, and is consistent with other average methods utilized by this Commission.

Q. Please explain other examples where the use of an average has been used by the Company to determine the appropriate level of revenue or expense to include in its general rate case filings?

A. A few examples come to mind regarding transmission revenue adjustments. For example, the Company uses a five-year average for OASIS wheeling revenues because these revenues vary year to year depending on electric energy market conditions. Avista has, in the current and previous rate cases, used the most recent five-year average as being representative of future expectations unless there are known events or factors that occurred during the period that would cause the average to not be representative of future expectations.

A second transmission revenue example includes the adjustment for Dry Gulch revenue. The current methodology used to normalize Dry Gulch revenue is a five-year average of actual revenue. A five-year average is used since the revenue can vary from year to year. The revenue is calculated using a 12-month rolling ratchet based on monthly peak demands. Load peaks are very sensitive to temperatures, which vary from year to year.

A third example, regarding injuries and damages expense, includes the restating adjustment described earlier in my testimony that replaces the amount accrued in the test period with a six-year rolling average of actual payments for injuries and damages not covered by insurance.

Q. Please continue your explanation of the adjustment columns on page 10.

A. The adjustment in column (PF16), **Pro Forma O&M Plant expense**, adjusts for incremental non-labor generation plant O&M costs planned for 2010 above the test period. As further explained by Mr. Storro, these additional expenditures are mainly due to major O&M expenditures planned for the Company's two thermal generation plants, Colstrip and Kettle Falls, and its Rathdrum CT peaking generation plant. This adjustment decreases Washington net operating income by $1,475,000.

The adjustment in column (PF17), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense and decreases Washington net operating income by $2,577,000.

Q. Please describe the pension expense portion of the Employee Benefits adjustment and Washington's share of this expense.

A. The Company's pension expense portion of this adjustment is determined in accordance with Financial Accounting Standard 87 ("FAS-87"), and has increased on a system basis from $12.1 million for the actual test year costs for the twelve months ended September 30, 2008, to $22.2 million for 2009. At this time the amounts included in this case are estimated with the most current available data as of January 2009. Preliminary Pension expense is determined by an outside actuarial firm, in accordance with FAS-87, and provided to the Company late in the first quarter of each year. These calculations and assumptions are reviewed by the Company's outside accounting firm annually for reasonableness and comparability to other companies. Due to the timing of this report, additional information may become known during the course of these proceedings that may require a modification to this adjustment.

As explained by Mr. Thies, the increase in pension expense is due primarily to the investment performance of plan assets during the major downturn in the financial markets experienced during the past year. In addition, the Pension Protection Act (PPA) of 2006 requires companies to annually increase the funding level of their pension plans in order to eventually achieve a fully funded plan.

As explained by Mr. Thies, Avista is very disciplined in its plan asset allocation and believes that its approach has helped to arrest what could have been an even greater decline in plan assets value. Many companies with Defined Benefit Pension Plans have experienced similar asset value declines and increased funding levels as a result of general market conditions, as discussed by Mr. Thies.

The pension levels noted above are for the Company as a whole. Pension expense, as with other employee benefits, is "loaded" onto actual labor costs, which are then assigned to various functional expense categories and accounts through the payroll process. Historically, approximately 60% of labor is recorded as O&M expense and 40% is recorded as capital. In our adjustment, a detailed analysis of labor charges was performed to more accurately determine the Washington O&M percentage of overall labor. Based on this analysis, Washington's share of the electric pension expense (pre-tax) amount included in this adjustment is approximately $2.9 million.

Q. Please now describe the medical insurance expense portion of the Employee Benefits adjustment and Washington's share of this expense.

A. The Company's medical insurance expense portion of this adjustment adjusts for the medical insurance costs planned for 2009 above the test period. Medical insurance expense has increased on a system basis from $14.3 million for the actual test year costs for the twelve months ended September 30, 2008, to $17.9 million for 2009. This increased cost is mainly due to increased large claims activity driven by various diagnostic categories such as cancer and heart disease, and an increase in the average age of our membership.

Avista has taken measures to directly decrease its self-funded plan costs. These measures include increasing the stop loss insurance reimbursement level, which decreases the premium expense with Avista's third party administrator. Avista also negotiated a new contract with its prescription benefit administrator and its third party administrator (TPA) to pass through the drug manufacturer rebates (in the past these rebates were left with the TPA.) Also, Avista is converting to a Preferred Provider Organization (PPO) program for its dental plan that provides savings to the participant, similar to medical plans with a PPO program. In addition to these current measures, Avista has made changes to co-pay levels and out of pocket maximums over the past five years to help reduce plan costs.

Again, as with other employee benefits, medical insurance expense is "loaded" onto actual labor costs, which are then assigned to various functional expense categories and accounts through the payroll process. Historically, approximately 60% of labor goes to O&M expense and 40% to capital. Washington's share of the electric medical insurance expense amount included in this adjustment is approximately $1.0 million.

Q. Please continue your explanation of the adjustment columns on page 10.

A. The adjustment in Column (PF18), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2009. Costs of system-wide insurance policies for 2009 varied from 2008, mainly for General Liability and Property insurance cost, which increased approximately $730,000 (system expense), due to increased coverage, Avista's growth, and higher premium rates. Property insurance rates were volatile because of extensive energy industry property damage in 2008 and adverse investment returns at insurance companies. Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. This adjustment decreases Washington net operating income by $184,000.

Q. Please continue your explanation of the adjustment columns on page 11.

A. The adjustment in Column (PF19), **Pro Forma Clark Fork PM&E,** adjusts the level of expense included in the test period for the Clark Fork Protection, Mitigation, and Enhancement (PM&E) expenses, to the Company's planned expenditures for 2010. Mr. Storro discussed the additional level of planned PM&E expenditures further within his testimony. The effect of this adjustment is to decrease Washington net operating income by $426,000.

The last column, Pro Forma Total, reflects total pro forma results of operations and rate base consisting of test period actual results (twelve-months ending September 30, 2008) and the total of all adjustments.

Q. Referring back to page 1, line 42, of Exhibit No._____(EMA-2), what was the actual and pro forma electric rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 6.50%. The pro forma rate of return is 4.37% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.68% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington electric operations to allow the Company an opportunity to earn its proposed 8.68% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $43,385,000, as shown on line 5, page 2 of Exhibit No._____(EMA-2). The resulting revenue requirement is shown on line 7 and amounts to $69,762,000, or an increase of 17.84% over pro forma general business revenues.

<u>IV. NATURAL GAS SECTION</u>

Q. On what test period is the Company basing its need for additional natural gas revenue?

A. The test period being used by the Company is the twelve-month period ending September 30, 2008, presented on a pro forma basis.

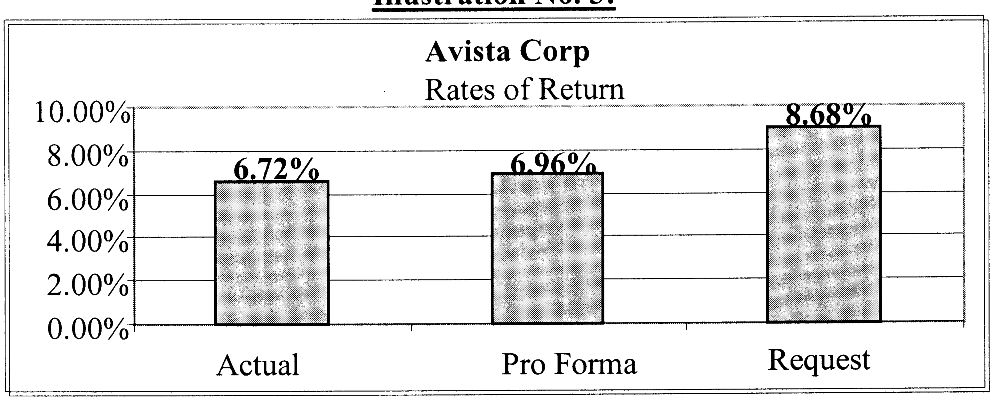
Q. When was the last change to base rates in the Washington jurisdiction?

A. The last change to base gas rates in Washington occurred on January 1, 2009 as a result of a settlement in Docket No. UG-080417.

Q. Could you please explain the different rates of return shown in your natural gas results presented in your testimony?

A. Yes. As discussed previously in the Electric Section, there are three different rates of return calculated. The actual ROR earned by the Company during the test period, the Pro Forma ROR determined in my Exhibit No.___(EMA-3), and the requested ROR. For convenience of comparison, please refer to the following illustration depicting these results for the Natural Gas Section:

<u>Illustration No. 3:</u>



Q. What are the primary factors driving the Company's need for additional natural gas revenues?

A. The Company's natural gas request is driven by changes in various operating cost components, mainly distribution operation and maintenance and administrative and general expenditures. This causes an increase in the fixed costs of providing gas service to customers. I describe the pro forma adjustments included in this case later in my testimony.

Revenue Requirement

Q. Would you please explain what is shown in Exhibit No._____(EMA-3)?

A. Exhibit No._____(EMA-3) shows actual and pro forma gas operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No._____(EMA-3) shows 2008 operating results (twelve-months ended September 30, 2008) and components of the average-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is pro forma results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn a 8.68% rate of return. Column (f) reflects pro forma gas operating results with the requested increase of $4,918,000.

Q. Would you please explain page 2 of Exhibit No._____(EMA-3)?

A. Yes. Page 2 shows the calculation of the $4,918,000 revenue requirement at the requested 8.68% rate of return.

Q. Would you now please explain page 3 of Exhibit No._____(EMA-3)?

A. Yes. Page 3 shows the derivation of the net operating income to gross revenue conversion factor. The conversion factor takes into account uncollectible accounts receivable, Commission fees and Washington State excise taxes. Federal income taxes are reflected at 35%.

Q. Now turning to pages 4 through 8 of your Exhibit No._____(EMA-3), would you please explain what those pages show?

A. Page 4 begins with actual operating results and rate base for the test period in column (b). Individual normalizing adjustments that are standard components of our annual reporting to the Commission begin in column (c) on page 4 and continue through column (u) on page 7. Individual pro forma and additional normalizing adjustments begin in column (PF1) on page 7 and continue through column (PF10) on page 8. The final column on page 8 is the total pro forma operating results and rate base for the test period.

<u>Standard Commission Basis Adjustments</u>

Q. Would you please explain each of these adjustments, the reason for the adjustment and its effect on test period State of Washington net operating income and/or rate base?

A. Yes, but before I begin, I will note that in addition to the explanation of adjustments provided herein, the Company has also provided workpapers outlining additional details related to each of the adjustments. The restating adjustments shown in columns *c* through *u* are consistent with methodologies employed in our prior cases and current regulatory principles.

The first adjustment, column (c) on page 4, entitled **Deferred FIT Rate Base**, reflects the rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing premiums, and contributions in aid of construction. These amounts are reflected on the average of monthly average balance basis. The effect on Washington rate base is a reduction of $27,674,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for Washington's portion of the net of tax, unamortized gain on the sale of the Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period scheduled to end in 2011. This accounting treatment was approved in Order No. 01 in Docket No. U-071805. This adjustment reflects the average of monthly averages amount of the deferred gain for the 2010 rate period. The effect on Washington rate base is a reduction of $42,000.

The adjustment in column (e), **Gas Inventory**, reflects the adjustment to rate base for the average of monthly average value of gas stored at the Company's Jackson Prairie underground storage facility through the test period. The effect on Washington rate base is an increase of $11,064,000.

The adjustment in column (f), **Weatherization and DSM Investment**, includes in rate base the balance (net of amortization) of Company investments in natural gas demand side management (DSM) and Weatherization consistent with Docket Nos. UG-991607, UG-041515, UG-050483, and UG-070805. Rate base has been restated to the average of monthly averages for the 2010 rate period. The effect of this adjustment on Washington rate base is zero at December 31, 2010, and the adjustment is therefore no longer necessary.

The adjustment in column (g), entitled **Customer Advances**, decreases rate base for funds advanced by customers for line extensions, as they are generally recorded as contributions in aid of construction at some future time. The effect of this adjustment on Washington rate base is a decrease of $52,000.

The adjustment in column (h), entitled **Depreciation True-up**, reflects a decrease in depreciation expense due to the utilization of new depreciation rates effective January 1, 2008 as approved in Docket No. UG-070805. These rates became effective after the three months October through December 2007 included in the test period. This adjustment annualizes the current effective rates for the test period. This adjustment increases Washington net operating income by $54,000.

Q. Please turn to page 5 and explain the adjustments shown there.

A. The column marked by a dash, and labeled **Subtotal Actual**, is a subtotal of columns (b) through (h) and reflects the standard rate base adjustments that are included in Commission Basis reporting.

The first adjustment on page 5 in column (i), entitled **Revenue Normalization & Gas Cost Adjustment**, is a 3-fold adjustment taking into account known and measurable changes that include revenue normalization (including the current authorized rates approved in Docket No. UG-080417), which reprices customer usage under presently effective rates, as well as weather normalization and an unbilled revenue calculation. Associated gas costs are replaced with gas costs computed using normalized volumes at the currently effective "weighted average cost of gas," or WACOG rates. Revenues associated with the temporary Gas Rate Adjustment Schedule 155 and Schedule 191 Tariff Rider are excluded from pro forma revenues, and the related amortization expense is eliminated as well. The January 16, 2009 gas cost reduction to customer charges was accomplished through Schedule 155, which is excluded from base revenues. Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $3,648,000.

The adjustment in column (j), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated with local business and occupation taxes, which the Company passes through to customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O Taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $4,000.

The adjustment in column (k), **Property Tax**, restates the test period accrued levels of property taxes to the most current information available and eliminates any adjustments related to the prior year. The effect of this particular adjustment is to increase Washington net operating income by $193,000.

The adjustment in column (l), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to increase Washington net operating income by $93,000.

The adjustment in column (m), entitled **Regulatory Expense Adjustment**, restates recorded 2008 regulatory expense to reflect the WUTC assessment rates applied to revenues for the test period. The effect of this adjustment is to decrease Washington net operating income by $9,000.

The adjustment in column (n), entitled **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to decrease Washington net operating income by $42,000.

Q. Please turn to page 6 and explain the adjustments shown there.

A. The first adjustment on page 6 in column (o), entitled **FIT**, adjusts the FIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items and matches the jurisdictional allocation of other Schedule M items to related Results of Operations allocations. This adjustment also reflects the proper level of deferred tax expense for the test period. The effect of this adjustment, all based upon a Federal tax rate of 35%, is to decrease Washington net operating income by $10,000.

The adjustment in column (p), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 1999 and 2008. This restating adjustment is made as a result of the Commission's Order in Docket No. UG-050843 and consistent with UG-070805. The effect of this adjustment is to increase Washington net operating income by $8,000.

The adjustment in column (q), **Eliminate A/R Expenses**, A/R representing Accounts Receivable, removes expenses associated with the sale of customer accounts receivable. The effect of this adjustment is to increase Washington net operating income by $55,000.

The adjustment in column (r), **Office Space Charges to Subs**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T and is consistent with Docket No. UG-070805 and UG-080417. The effect of this adjustment is to increase Washington net operating income by $1,000.

The adjustment in column (s), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to decrease Washington net operating income by $51,000.

The adjustment in column (t), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, sponsorships and dues and donations included in error in the test period actual results. The effect of this adjustment is to increase Washington net operating income by $56,000.

Q. Please turn to page 7 and explain the adjustments shown there.

A. The adjustment in column (u), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies, and applied to Washington's pro forma level of rate base, produces a pro forma level of tax deductible interest expense. The federal income tax effect of the restated level of interest for the test period increases Washington net operating income by $149,000.

The next column on page 7, entitled **Restated Total**, subtotals all the preceding columns (b) through column (u), exclusive of the previously discussed subtotal column. These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports.

<u>Pro Forma Adjustments</u>

Q. Please explain the significance of the 10 columns subsequent to the Restated Total column on page 7 of your Exhibit No._____(EMA-3).

A. The adjustments starting on page 7 are pro forma adjustments to reflect known and measurable changes between the test period and the pro forma period. In this case, they encompass revenue and expense items, and natural gas capital projects. These adjustments bring the operating results and rate base to the final pro forma level for the test year.

Q. Please continue with your explanation of the adjustments on page 7.

A. The adjustment in column (PF1), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in PF2. Test period wages and salaries are restated as if the wage and salary increases through March 2010 were in place during the entire pro forma test period. The methodology behind this adjustment is consistent with Docket No.

UG-050483 and UG-070805. The effect of this adjustment on Washington net operating income is a decrease of $511,000.

The adjustment in column (PF2), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating their salaries as if wage and salary increases through March 2010 were in place for the entire pro forma test period. This adjustment takes into account changes in executive staffing made during 2008 and includes compensation for the planned executive team in 2010 only. Compensation costs for non-utility operations are excluded as executives routinely charge a portion of their time to non-utility operations, commensurate with the amount of time spent on such activities. The current executives' salary allocations are set at their expected pro forma test period utility/non-utility percentage splits. The impact of this adjustment on Washington net operating income is a decrease of $44,000.

The adjustment in column (PF3), **Pro Forma JP Storage**, pro forms revenues, expenses, capital investment and inventory for the increased storage capacity and deliverability associated with the Jackson Prairie (JP) Storage facility that was approved by the Commission in Order No. 08 (Docket No. UG-080417). In 2008, Avista ended its natural gas storage release contract with Terasen Gas. The revenues of $2,561,000 from the release of this contract have been eliminated from the test period. Gas inventory has been increased by $1,047,000, due to the recouped storage. In addition, a multi-year expansion project at the facility was in service in October 2008, which increased deliverability, increasing depreciation and property taxes expense by approximately $284,000, and increasing net rate base by $7,875,000. The impact of this adjustment decreases Washington net operating income by $1,778,000 and increases rate base by $8,922,000.

The adjustment in column (PF4), **Pro Forma Capital Additions 2008**, pro forms in the capital cost and expenses associated with adjusting the 2008 average-monthly-average plant related balances to actual end-of-period balances for plant in service at December 31, 2008. The capital costs have been included for December 31, 2008 pro forma period with the associated depreciation expense and property tax, as well as the appropriate accumulated depreciation and deferred income tax rate base offsets. This adjustment was made under the direction of Company witness Mr. DeFelice and is described further in his testimony. This adjustment increases Washington net operating income by $294,000 and increases rate base by $1,234,000.

The adjustment in column (PF5), **Pro Forma Capital Additions 2009**, pro forms in the capital cost and expenses associated with pro forming in capital expenditures for 2009. This adjustment includes projects completed during 2009, and thus were normalized to reflect annual amounts, and projects expected to be completed and transferred to plant-in-service by December 31, 2009. The capital costs have been included for their appropriate pro forma period with the associated depreciation expense and property tax, as well as the appropriate accumulated depreciation and deferred income tax rate base offsets. This adjustment also reduces the 2008 vintage plant net rate base (including accumulated depreciation and deferred FIT) to an end of period December 31, 2009 adjusted balance. This adjustment was also made under the direction of Mr. DeFelice and is described further in his testimony. This adjustment decreases Washington net operating income by $596,000 and increases rate base by $6,094,000.

Q. Please describe the adjustments on page 8.

A. The adjustment in column (PF6), entitled **Pro Forma Asset Management,** pro forms in the gas O&M expense associated with the Asset Management Program as described further by Mr. Kinney. This adjustment decreases Washington net operating income by $57,000.

The adjustment in column (PF7), entitled **Pro Forma Incentives,** adjusts the test year incentive expense to the 2008 incentive expense expected to be paid in 2009 for the 2008 incentive plan and removes any part of the 2008 executive incentive payout that was not based on the Customer Satisfaction and Reliability targets (as further explained in the Electric Section). This adjustment also pro forms in a 6 year average (as further explained in the Electric Section). The impact of this adjustment on Washington net operating income is a decrease of $99,000.

The adjustment in column (PF8), **Pro Forma Information Services**, pro forms in the administrative and general (A&G) expenses associated with incremental known and measureable changes for labor and non-labor informational services costs planned for 2010 above the test period (as explained in the Electric Section above). The impact of this adjustment on Washington net operating income is a decrease of $292,000.

The adjustment in column (PF9), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense (as explained in the Electric Section above) and decreases Washington net operating income by $681,000.

The adjustment in Column (PF10), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2009 (as explained in the Electric Section above). The impact of this adjustment on Washington net operating income is a decrease of $51,000.

The last column on page 8, **Pro Forma Total**, reflects total pro forma results of operations and rate base consisting of twelve-months ended September 30, 2008 actual results and the total of all normalizing and pro forma adjustments.

Q. Referring back to page 1, line 43, of Exhibit No._____(EMA-3), what was the actual and pro forma gas rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 6.72%. The pro forma rate of return is 6.96% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.68% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington gas operations to allow the Company an opportunity to earn its proposed 8.68% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $3,059,000, as shown on line 5, page 2 of Exhibit No._____(EMA-3). The resulting revenue requirement is shown on line 7 and amounts to $4,918,000, or an increase of 2.28% over pro forma general business and transportation revenues.

V. ALLOCATION PROCEDURES

Q. Have there been any changes to the Company's system and jurisdictional procedures since the Company's last general electric and natural gas cases, Docket Nos. UE-080416 and UG-080417?

A. No. For ratemaking purposes, the Company allocates revenues, expenses and rate base between electric and gas services and between Washington, Idaho, and Oregon jurisdictions where electric and/or gas service is provided. The current methodology was implemented in 1994 and has not changed. The allocation factors used in this case have been provided with my workpapers.

Q. Does that conclude your pre-filed direct testimony?

A. Yes, it does.