Exhibit No. ___(EMA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-11_____________

DOCKET NO. UG-11_____________

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[1]. 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 ten and

[1] Currently I keep a CPA-Inactive status with regards to my CPA license.

one-half years, I have assisted or led 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 other witnesses in this case. In addition, I will explain the Company's request for deferred accounting treatment of changes in generating plant operation and maintenance (O&M) costs related to its Coyote Springs 2 natural gas-fired plant and its 15% ownership share of the Colstrip 3 & 4 coal-fired generating plants. Lastly, I will explain the Company's compliance with the UTC Commission Order No. 7 in Docket Nos. UE-100467 and UG-100468, regarding the Company's review of its accounting for its Optional Renewable "Buck-a-Block" Power Rate Program, its accounting policies and procedures for allocation of costs between utility and non-utility accounts and the internal audit of its expenditures[2], and how the Company's employee incentive program complies with the Commission's Final Orders in previous Avista general rate cases.[3]

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 2010 operating results (twelve-month period ending December 31, 2010), pro

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[2] Order No. 7, Dockets UE-100467 & UG-100468, paragraph 16.

forma, and proposed electric and natural gas operating results and rate base for the State of Washington. The exhibits also show the calculation of the general revenue requirement, the derivation of the Company's overall proposed rate of return, the derivation of the net-operating-income-to-gross-revenue-conversion factor, and the specific pro forma adjustments proposed in this filing.

I am also sponsoring Exhibit Nos. ___(EMA-4) and (EMA-5) which are the Company's compliance reports: "Review of Accounting Procedures Relating to Optional Renewable Power Rate Program", and "Internal Review of Accounting Procedures," respectively.

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 6.12% and 6.31%, respectively. Both return levels are below the Company's requested rate of return of 8.23%. The incremental revenue requirement necessary to give the Company an opportunity to earn its requested ROR is $38,274,000 for the electric operations and $6,207,000 for the natural gas operations. The overall base electric increase associated with this request is 9.05%. The base natural gas increase is 4.00%.

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[3] Order No. 7, Docket UE-100467 & UG-100468, Settlement Stipulation, page 8, section h.

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 is 7.91 %, effective December 1, 2010 for both our electric and natural gas systems.

III. ELECTRIC SECTION

Test Period for Ratemaking Purposes

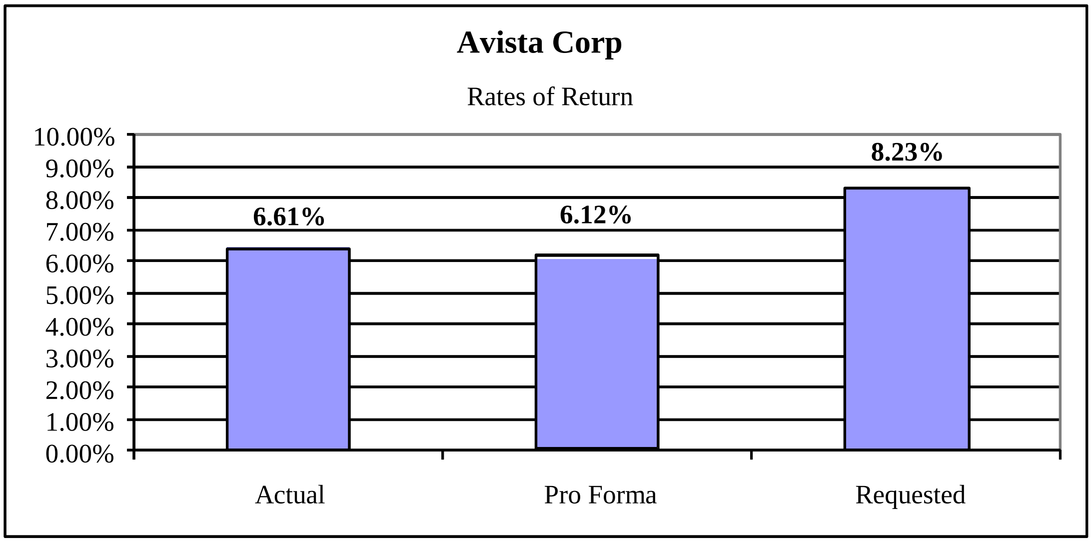
Q. On what test period is the Company basing its need for additional electric revenue?

A. The test period being used by the Company is the twelve-month period ending December 31, 2010, presented on a pro forma basis. Currently authorized rates were based upon the twelve-months ending December 31, 2009 test year utilized in UE-100467, 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 comparison, please refer to Illustration No. 1 below:

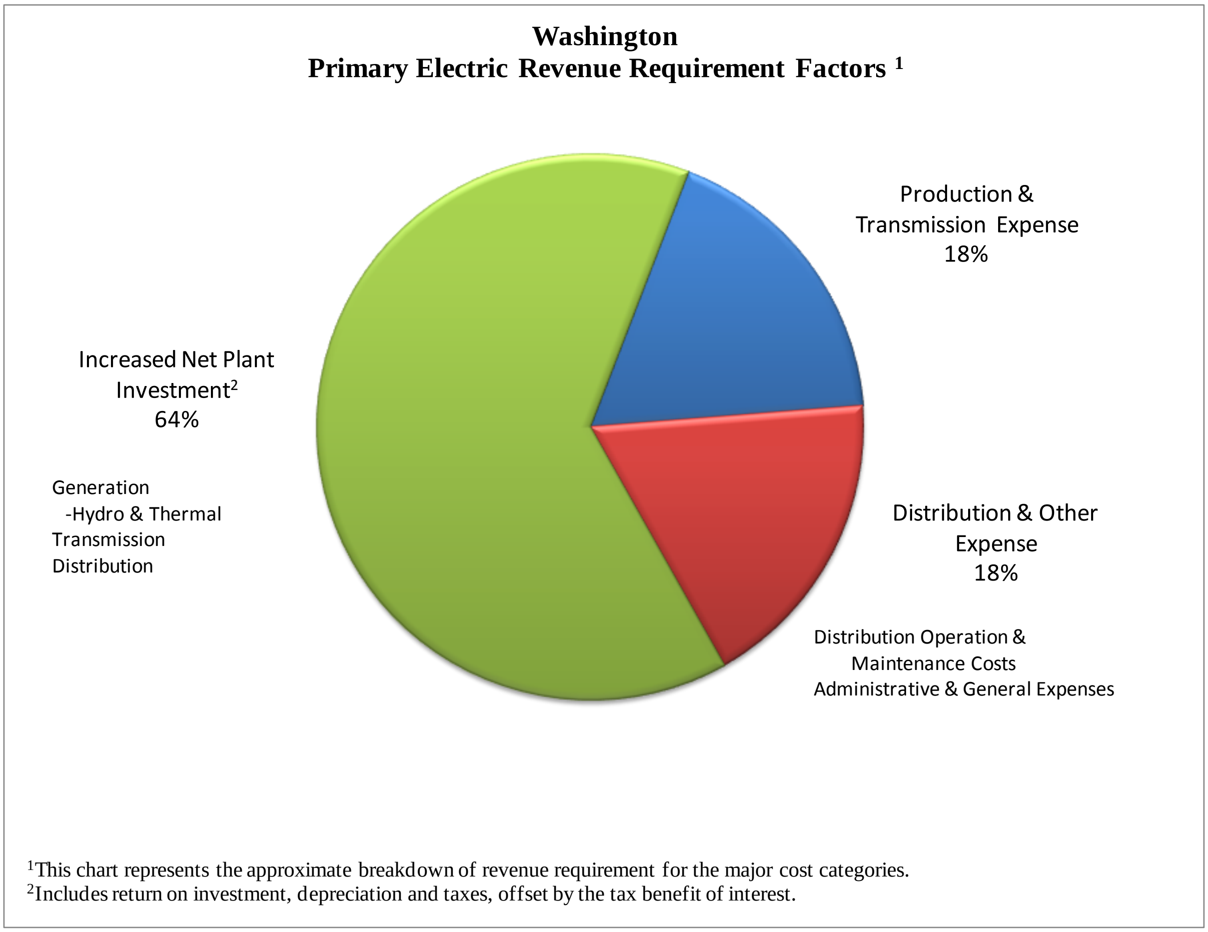
<u>Illustration No. 1:</u>



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.

<u>Illustration No. 2:</u>



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

A. The first segment, representing increases in Net Plant Investment, comprises approximately 64% of the overall request, and is due to an increase of approximately $71.7 million in net rate base for the Washington jurisdiction.

The next two segments, representing 18% each of the Company's overall request, include the increases in Production and Transmission Expense, related to increases in net power supply and transmission expenditures, and the Distribution, O&M and A&G Expense. This latter segment includes increases to all other operating categories, such as distribution expenses, including increases in vegetation management expenses, and administrative and general expenses, as well as increases in employee medical costs.

In addition to the categories (or segments) noted in Illustration No. 2 above, the Company has also included an Energy Efficiency Load Adjustment (EELA) increasing the Company's revenue requirement by approximately $4.3 million. The EELA is spread to each of the major categories in the pie chart. The reduced load from the EELA causes an increase in revenue requirement in each of the major cost categories, because the foregone retail revenue from the load reduction is designed to recover costs in each of the categories.

Q. What were the major components of the Increased Net Plant Investment?

A. Looking at the changes to "gross" plant in service, Washington "gross" plant increased by approximately $130.8 million, as compared to what is currently included in rates. In order to meet the energy and reliability needs of our customers, $51.9 million of this increase is due to the Company's investment in thermal and hydro generating facilities, as well as additional transmission investment. Distribution "gross" plant increased $51.0 million above the current level included in rates, while general and intangible "gross" plant increased $27.9 million. After adjusting for accumulated depreciation and amortization, and accumulated deferred income taxes, the <u>net</u> increase to rate base from these items is $68.9 million. Lastly, the Company included a working capital adjustment in this case of $21 million, which added $2.8 million to the Company's adjusted rate base above the authorized working capital amount approved in the Company's previous general rate case.

The specific 2011 pro forma capital expenditures undertaken by the Company to expand and replace its generation, transmission and distribution facilities are discussed further by

Company witnesses Mr. Lafferty regarding production assets, and Mr. Kinney regarding transmission and distribution assets. In addition to discussing the actual restating and pro forma adjustments made regarding net plant investment, Company witness Mr. DeFelice also describes the certain 2010 major plant additions (generation, transmission, distribution, and general plant) annualized for purposes of the Company's case.

Q. Mr. DeFelice explains the restating 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 sustain reliability and safety. 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.

In addition, as Mr. DeFelice explains in his testimony, because of the design of the Retail Revenue Credit in the Energy Recovery Mechanism (ERM), the Retail Revenue Credit credits back to customers the revenues from new customer growth that would otherwise cover a portion of new capital investment and increases in O&M costs. Because these new retail revenues are credited back to customers through the mechanics of the ERM, unless the new capital investment and O&M is pro formed into retail rates in the general rate case, Avista will not receive recovery of these costs.

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

A. Yes. As discussed in Company witness Mr. Johnson's testimony, the level of Washington's share of power supply expense has increased by approximately $5.9 million ($9.0 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 caused by numerous factors, primarily higher prices for market transactions, higher effective costs for Mid-Columbia purchased hydro generation, with higher costs partially offset by the Energy Efficiency Load Adjustment.

The Company has also included additional transmission expenses of approximately $1.4 million for 2012 due to a North American Electric Reliability Corporation (NERC) Alert as discussed by Mr. Kinney.

Q. Could you please identify the main components of the Distribution, O&M and A&G Expense shown in the Illustration above?

A. Yes. A number of expense items have increased since the 2009 test year pro forma used in the last rate case. For example, employee benefits such as wages, pension and medical insurance expenses have increased.

We are utilizing a 2010 test year, however, new general electric rates resulting from this filing are not expected to go into effect until the first half of 2012. Accordingly, the Company has included a number of pro forma adjustments to capture some of the cost changes that the Company will experience from the test year. In particular, the Company has pro formed in the increased costs associated with electric distribution vegetation management costs of $2.1 million as discussed by Mr. Kinney, and increased medical expenses of approximately $1.4 million. Company witness Ms. Feltes discusses the cause of the increased medical expenses in her testimony. These two adjustments alone equate to over 52% of the distribution and other expense category shown in Illustration No. 2.

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 2010 actual operating results 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 an 8.23% rate of return. Column (f) reflects pro forma electric operating results with the requested increase of $38,274,000. The restating adjustments shown in columns *(c)* through *(aj),* of pages 5 through 9 of Exhibit No._____(EMA-2), are consistent with current regulatory principles and the treatment reflected in the prior Commission Order in Docket No. UE-100467, with a few proposed changes by the Company as described in my testimony below.

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

A. Yes. Page 2 shows the calculation of the $38,274,000 revenue requirement at the requested 8.23% rate of return.

Q. What does page 3 of Exhibit No._____(EMA-2) show?

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital 8.23%. Company witness Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Company witness Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

Q. Would you now please explain page 4 of Exhibit No._____(EMA-2)?

A. Yes. Page 4 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 5 through 11 of your Exhibit No._____(EMA-2), would you please explain what those pages show?

A. Yes. Page 5 begins with actual operating results and rate base for the 2010 test period in column (b). Individual normalizing and restating adjustments that are standard components of our annual reporting to the Commission begin in column (c) on page 5 and continue through column (aj) on page 9. Individual pro forma adjustments begin in column (PF1) on page 10 and continue through column (PF10) on page 11. The final column on page 11 is the total pro forma operating results and rate base for the test period.

<u>Standard Commission Basis and Restating 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, both in hard copy and electronic formats, outlining additional details related to each of the adjustments.

The first adjustment, column (c) on page 5, 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) and bond refinancing premiums. These amounts are reflected on the average-of-monthly-average balance basis. The effect on Washington rate base is a reduction of $184,234,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the removal of the amortization expense included in the Company's 2010 test period related to Washington's portion of the amortized 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. The average of monthly averages (AMA) amount of the deferred gain for the 2012 rate period is zero. The use of AMA for the rate period was ordered in Order No. 01 in Docket No. U-071805. The effect on

Washington rate base is a zero. The effect on Washington net operating income is an increase of $84,000.

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 UTC 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 $191,000. The effect of the reallocation on Washington rate base is a decrease of $1,493,000.

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 $365,000.

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 rate base is a decrease of $676,000.

The adjustment in column (h), **Customer Advances**, which decreases rate base for money advanced by customers for line extensions, as they will be recorded as contributions in aid of construction at some future time. The effect on Washington rate base is a decrease of $279,000.

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

A. Page 6 starts with the adjustment in column (i), **Customer Deposits** that deducts from electric rate base the average-of-monthly-averages of customer deposits held by the Company, as ordered by this Commission in Docket UE-090134. The corresponding interest paid on customer deposits is reclassified to utility operating expense, at the current UTC interest rate of 0.26%. The effect on Washington rate base is a decrease of $3,419,000. The effect on Washington net operating income is a decrease of $5,000.

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 2012 rate period. The effect on Washington rate base is an increase of $14,403,000.

The adjustment in column (k), **Restating CDA Settlement,** adjusts the 2010 AMA test period annual amortization expense, net asset ($41.6 million (system) of payments and deferred costs) and DFIT balances related to the 2008 through 2010 CDA Tribe Settlement payments (Past Storage/§10(e)) and deferred costs to a 2012 AMA basis. The regulatory treatment of the CDA Settlement was approved by the Commission in Docket No. UE-080416. The effect on Washington rate base is an increase of $852,000 above that in the test period. The effect on Washington net operating income is a decrease of $35,000.

The adjustment in column (l), **Restating CDA Settlement Deferral,** adjusts the net assets and DFIT balances associated with the 2008/2009 past storage and §10(e) charges deferred for future recovery to a 2012 AMA basis, and records the annual amortization expense based on a ten-year amortization, as approved in Docket No. UE-100467. The effect on Washington rate base is an increase of $832,000. The effect on Washington net operating income is a decrease of $70,000.

The adjustment in column (m), **Restating CDA/SRR (Spokane River Relicensing) CDR,** adjusts the net assets and DFIT balances associated with the CDA Tribe settlement 4(e) Spokane River relicensing conditions, deferred for future recovery, to a 2012 AMA basis. The expense portion of this adjustment includes the annual amortization of the net total asset ($12 million (system) of payments and deferred costs); amortization of the deferred balance over a ten-year period, as approved in Docket No. UE-100467; and the annual $2 million (system) of CDR payment expense over the 2010 AMA expense level. The effect on Washington rate base is an increase of $703,000. The effect on Washington net operating income is a decrease of $429,000.

The adjustment in column (n), **Restating Spokane River Deferral,** adjusts the net asset and DFIT balances related to the Spokane River deferred relicensing costs to a 2012 AMA basis, and records the annual amortization expense based on a ten-year amortization as approved in Docket No. UE-100467. The effect on Washington rate base is an increase of $399,000. The effect on Washington net operating income is a decrease of $34,000.

The adjustment in column (o), **Restating Spokane River PM&E Deferral,** adjusts the net asset and DFIT balances related to the Spokane River deferred PM&E costs to a 2012 AMA basis, and records the annual amortization expense based on a ten-year amortization as approved in Docket No. UE-100467. The effect on Washington rate base is an increase of $253,000. The effect on Washington net operating income is a decrease of $22,000.

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

A. Page 7 starts with the adjustment in column (p), **Restating Montana Riverbed Lease**, includes the 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 accounting treatment of the deferred payments, including accrued interest, to be amortized over the remaining eight years of the agreement starting on January 1, 2009. This restating adjustment includes one-eighth of the deferred balance amortization and the increase in the annual lease payment expense for the additional annual inflation. This adjustment decreases Washington net operating income by $35,000 and increases rate base by $1,979,000.

The adjustment in column (q), **Restating Lancaster Amortization,** adjusts the net asset and DFIT balances related to the 2010 ($6.8 million Washington) deferred Lancaster plant Power Purchase Agreement (PPA) to a 2012 AMA basis, and records the annual amortization expense based on a five-year amortization, as approved in Docket No. UE-100467. The effect of this adjustment on Washington net operating income is a decrease of $810,000. The effect on Washington rate base is an increase of $3,020,000.

The adjustment in column (r), **Restating 2010 Major Capital,** restates certain plant additions included in the test year on an AMA basis, together with the associated accumulated depreciation and deferred federal income taxes at a 2010 end of period basis, as described further by Mr. DeFelice. This adjustment includes the associated depreciation expense on the additions and removes any prior period depreciation expense included in the 2010 test period. The 2010 electric capital additions that were annualized included the generation projects that were agreed to in the Docket No. UE-100467, two major transmission projects, two asset management distribution projects and the allocated portion of one major general plant addition. The effect of this adjustment on Washington net operating income is a decrease of $91,000. The effect on Washington rate base is an increase of $17,230,000.

The adjustment in column (s), **Working Capital**, increases total rate base for the Company's working capital adjustment. Although there are various appropriate methods used to determine a Company's working capital, to reduce the issues in this case[4], the Company has calculated its working capital in this proceeding using the Investor Supplied working Capital (ISWC) method. This calculation was computed based on the Company's understanding of the ISWC methodology proposed by Staff during settlement discussions in the Company's last general rate case, Docket No. UE-100467. Although neither the method nor the calculation were agreed to during that proceeding, the parties accepted for settlement purposes the $18.2 million amount for working capital proposed by Staff using the ISWC method[5]. The effect on Washington rate base is an increase of $21,001,000 (or $2.8 million over that previously authorized).

The next column marked by a dash, entitled **Subtotal Actual** represents actual operating results and rate base plus standard rate base adjustments that are included in Commission Basis reporting, plus additional restating adjustments required to annualize previous approved rate base items.

Q. Please continue describing the adjustments on page 7 that continue after the Subtotal Actual column.

[4] The Company, of course, reserves the right to argue a different methodology in a future proceeding if appropriate.

A. The adjustment in column (t), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated with local business and occupation (B & O) taxes, which the Company passes 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 $29,000.

The adjustment in column (u), **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 adjustment decreases Washington net operating income by $662,000.

The adjustment in column (v), **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 decrease Washington net operating income by $306,000.

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

A. Page 8 starts with the adjustment in column (w), **Regulatory Expense**, which restates recorded 2010 regulatory expense to reflect the UTC 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 an increase to Washington net operating income of $33,000.

The adjustment in column (x), **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages

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[5] The Commission has also recently approved a similar ISWC approach in Docket No. UE-100749, Washington

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 increase Washington net operating income by $736,000.

The adjustment in column (y), **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 adjusts the appropriate level of production tax credits and income tax credits on qualified generation.

The net FIT and production tax credit adjustments decrease Washington net operating income by $529,000. Adjusting for the proper level of deferred tax expense for the test period increases Washington net operating income by $272,000. This adjustment also reflects the proper level of amortized income tax credit for the test period decreasing Washington net operating income by an additional $15,000. Therefore, the net effect of this adjustment, all based upon a Federal tax rate of 35%, is to increase Washington net operating income by $272,000.

The adjustment in column (z), **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 commission-approved deferral and recovery mechanism. 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 $4,700,000.

The adjustment in column (aa), **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 $8,000.

The adjustment in column (ab), **Eliminate A/R Expenses**, removes expenses incurred associated with the fees charged the Company for its customer accounts receivable program. The Company's accounts receivable program was terminated in December 2010. The effect of this adjustment is to increase Washington net operating income by $141,000.

The adjustment in column (ac), **Office Space Charged to Subsidiaries**, 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 our last general rate case in Docket No. UE-100467. The effect of this adjustment is to increase Washington net operating income by $4,000.

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

A. Page 9 starts with the adjustment in column (ad), **Restate Excise Taxes**, which removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to increase Washington net operating income by $70,000.

The adjustment in column (ae), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 2001 and 2010. This restating adjustment is made as a result of the Commission's Order in Docket No. UE-050482 and is consistent with Docket No. UE-100467. The effect of this adjustment is to increase Washington net operating income by $52,000.

The adjustment in column (af), **Revenue Normalization**, is an adjustment taking into account known and measurable changes that include revenue repricing (including the current authorized rates approved in Docket No. UE-100467), 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. Company witness Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $19,882,000.

The adjustment in column (ag), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, dues and donations, etc., included in error in the test period actual results, and removes or restates other expenses incorrectly charged between service and or jurisdiction totaling approximately $215,000. I describe further the process for removing or restating certain expenses from the Company's test period in Section VII (Compliance with Commission Order No. 7) discussed below.

The Company also removed 50% of director meeting expenses, as ordered in Docket No. UE-090134, and 10% of director fees totaling approximately $78,000. Lastly, this adjustment removes Washington's electric portion of consulting services, totaling $1.52 million from the test period to reduce the revenue requirement requested in this case. The effect of this adjustment is to increase Washington net operating income by $1,178,000.

Q. As noted above, the Company removed 10% of Director Fee expenses. What is the basis for removing 10% of these costs?

A. In 2010 the Company requested from each of its directors, based on their actual experience, the estimated time spent on utility versus non-utility duties and responsibilities. The responses from the Directors indicated that approximately 90% of the Directors' time is dedicated to utility matters, and approximately 10% to non-utility.

This 90/10 split is consistent with the average split that has been used in recent years by Avista's officers. Following the sale of Avista Energy in 2007, the officers of Avista Corp now spend on average approximately 90% of their time on the utility, and 10% on the remaining subsidiaries.

In Docket Nos. UE-090134 and UG-090135. Order No. 10, in reference to a 90/10 sharing for D&O insurance, the Commission stated:

> D&O insurance is a benefit that <u>is part of the compensation package offered to attract and retain qualified officers and directors. Accordingly, it makes sense to split the costs in the same manner we require other elements of their compensation to be shared.</u> Based on the formula currently used to allocate officer compensation between ratepayers and shareholders, this results in 90 percent of the costs being included for recovery in rates. (emphasis added) (See page 56, paragraph 137)

This Commission, as shown above, has recognized that D&O insurance is part of the "compensation package" (splitting such costs on a 90/10 basis). Similarly, Directors' fees, like D&O insurance referred to above, are a part of the Directors' compensation package offered to attract and retain qualified directors. Based on the actual time dedicated to the utility, a 90/10 sharing should be applied to Directors' fees. Director fees paid to board members for their duties specific to other Avista boards, i.e. Advantage I.Q., are otherwise charged 100% to non-utility. Using a 90/10 sharing for the remaining director fees paid for participating in Avista Corp./Utility board meetings reduced the Company's expense included in this filing by approximately $58,000.

Q. Please continue with your explanation of adjustments on page 9.

A. The adjustment in column (ah), **Restating Incentives,** restates the actual incentives included in the Company's test period using a six-year average adjusted by the Consumer Price Index. I discuss further in Section VII (Compliance with Commission Order No. 7) the basis for the use of a six-year average. The effect of this adjustment is to increase Washington net operating income by $1,267,000.

The adjustment in column (ai), **Remove Buck-A-Block,** removes the impact of the 2010 remaining expense associated with the Optional Renewable "Buck-a-Block" Power Rate Program included in the Company's 2010 test period. As ordered by the Commission in Docket No. UE-100467, Order No. 7, in 2010 the Company created a balancing account to track all costs associated with the Company's Buck-A-Block program, removing the impact of the Buck-A-Block program from base rates. In Section VII (Compliance with Commission Order No. 7) discussed below, I discuss further the Company's compliance with Commission Order No. 7. The effect of this adjustment is to decrease Washington net operating income by $7,000.

The adjustment in column (aj), **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. As applied to Washington's pro forma level of rate base, this 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 $23,000.

The last column on page 9, entitled **Restated Total**, subtotals all the preceding columns (b) through column (aj), excluding the 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[6].

<u>Pro Forma Adjustments</u>

Q. Please explain the significance of the 10 columns beginning at page 10 on your Exhibit No.____(EMA-2).

A. The adjustments starting on page 10 are pro forma adjustments that recognize the jurisdictional impacts of items that will impact the pro forma operating period 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 test year.

Q. Please continue with your explanation of the adjustments starting on page 10.

[6] The restated total also includes an increase in expense necessary to annualize certain 2010 expenses included in the test period as restating adjustments, (i.e. Lancaster Amortization, Montana riverbed lease, Spokane River and CDA Tribe Settlement expense), to annualize certain major plant additions which occurred in 2010, and includes a reduction to expense for a 6-year average of incentives.

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, 2012 through December 31, 2012, using historical loads. Mr. Johnson's testimony outlines the system level of pro forma power supply revenues and expenses 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 decrease Washington net operating income by $19,460,000.

The adjustment in column (PF2), **Pro Forma Energy Efficiency Load Adjustment,** reflects the reduction in retail revenues due to DSM requirements, the resulting savings in power supply expense, and includes the change in all other revenue related expenses and taxes associated with this adjustment, as described in detail by Mr. Ehrbar. The effect of this adjustment on Washington net operating income is a decrease of $2,677,000.

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 adjustment PF4. For non-union employees, test period wages and salaries are restated to include the March 2011 overall actual increase of 2.8%, and 10 months of the planned March 2012 increase of 2.5%. Company witness Ms. Feltes discusses the Company's overall compensation plan and notes that the 2.5% minimum increase was presented to the Compensation Committee of the Board of Directors and was approved at the Board's May 2011 meeting.

Also included in this adjustment are the 2011 and 2012 union contract increases agreed to in 2010 of 3% for both years. The methodology behind this adjustment is consistent with that used in the Company's previous Docket No. UE-100467. The effect of this adjustment on Washington net operating income is a decrease of $1,290,000.

The adjustment in column (PF4), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating executive compensation test period salary expense to actual salary levels at 2011. This adjustment reflects the annual increase for the actual overall 2011 officer increase of 3.79%. 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, based on a survey of each executive. The methodology behind this adjustment is consistent with what was approved in Docket No. UE-090134. The impact of this adjustment on Washington net operating income is a decrease of $58,000.

The adjustment in 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, 2012 through December 31, 2012. The net effect of the transmission revenue and expense adjustments decreases Washington net operating income by $1,429,000.

Q. Please now turn to page 11 and continue with your explanation of the adjustments included on that page.

A. Column (PF6), **Pro Forma Capital Additions 2011**, reflect certain 2011 capital additions to be completed and transferred to plant-in-service by December 31, 2011, together with the associated accumulated depreciation and deferred federal income taxes at a 2012 AMA basis, as described further by Mr. DeFelice. This adjustment also includes associated expenses (depreciation expense and property taxes) and offsets to expenses for the pro forma additions. This adjustment decreases Washington net operating income by $407,000 and increases rate base by $27,289,000.

The adjustment in column (PF7), **Pro Forma Noxon Generation 2011/2012,** pro forms in the 2011 Noxon Unit #2 generation plant upgrade (approved in the 2010 rate case), and the 2012 Noxon Unit #4 generation plant upgrade at a 2012 AMA basis, as explained further by Mr. Lafferty.

These unit upgrades are planned to increase unit efficiency and boost unit ratings. The additional generation from the Noxon Unit #2 and Unit #4, completion planned for May of 2011 and May 2012, respectively, has also been included in the Aurora Dispatch Model for the rate year, as discussed by Company witness Mr. Kalich. Including the additional generation from these Noxon upgrade in the Dispatch Model, ultimately reducing power supply expenses for customers in the 2012 rate year, and including these project in rate base for the rate period provides a proper match in revenues with expenses for these projects. The Noxon Unit #4 project was included in rate base and within the Aurora model at approximately 67% of the cost and generation (equivalent to 8 months due to an May 1, 2012 effective date). This adjustment decreases Washington net operating income by $208,000 and increases rate base by $8,697,000.

The adjustment in column (PF8), **Pro Forma Vegetation Management**, pro forms in the additional distribution vegetation management (VM) O&M expense needed to reduce the distribution VM cycle (expense level) to a four-year cycle (expense level) to be used in 2012, as described further by Mr. Kinney. Mr. Kinney also explains that Avista is required to report its actual spend to the Commission annually within the Company's Commission Basis Report, maintaining a one-way balancing account to track any funds under-spent (currently for 2011 the required spend is $4.025 million). In the event any dollars for vegetation management are not spent in any given year, that unspent balance will be accounted for and spent in subsequent year(s) or credited back to customers. In this filing the Company has requested an increase in the annual required spend amount from the current $4.025 million to $6.8 million. This adjustment decreases Washington net operating income by $1,800,000.

The adjustment in column (PF9), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense and decreases Washington net operating income by $1,070,000.

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 approximately $19.5 million for the actual test year costs for the twelve months ended December 31, 2010, to $20.6 million for 2012. At this time the amounts included in this case are based on the most current available data. 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.

The increase in pension expense is due primarily to the investment performance of plan assets 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, which also impacts the plan asset balance and level of expense.

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 2011 above the test period. Medical insurance expense has increased on a system basis from $20.54 million for the actual test year costs for the twelve months ended December 31, 2010, to $25.27 million for 2011. As discussed by Ms. Feltes, this increase in medical cost is due to an aging workforce requiring more health care at an ever increasing cost, which is consistent with what is occurring on a national level. Large claims activity driven by various diagnostic categories such as cancer and heart disease are also to blame for a portion of the increase. Ms. Feltes also discusses the measures taken by the Company to mitigate the increases.

The net impact of the increases in pension and medical costs is an increase in Washington expense of approximately $1.65 million.

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

A. 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 2011. Costs of system-wide insurance policies for 2011 varied only slightly from those policies in 2010. Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. In addition, Avista has removed a total of 10% of the total Directors' and Officers' insurance expense as ordered in Docket No. UE-09134. This adjustment increases Washington net operating income by $101,000.

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 December 31, 2010) and the total of all adjustments.

Q. Referring back to page 1, line 43, 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 6.61%. The pro forma rate of return is 6.12% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.23% 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 8.23% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $23,778,000, as shown on line 5, page 2 of Exhibit No._____(EMA-2). The resulting revenue requirement is shown on line 7 and amounts to $38,274,000, or an increase of 9.05% over pro forma general business revenues.

IV. NATURAL GAS SECTION

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 December 31, 2010, presented on a pro forma basis.

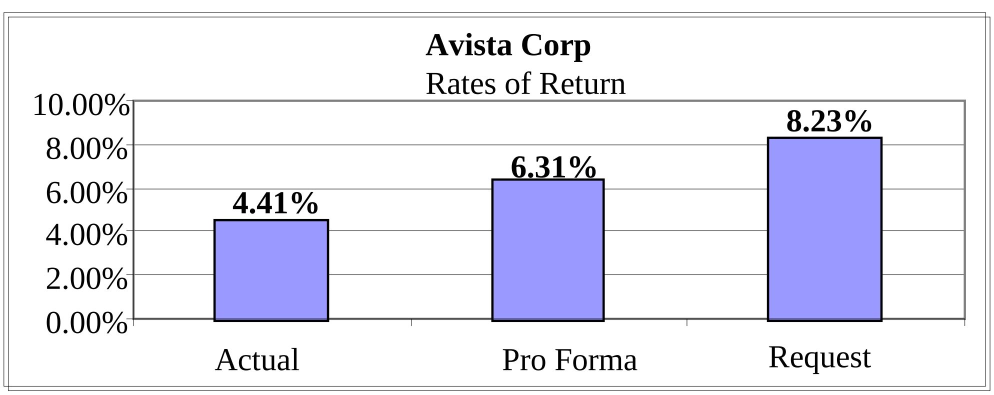
Q. When was the last change to base rates in the Washington jurisdiction?

A. The last change to base gas rates in Washington occurred on December 1, 2010 as a result of the Order received in Docket No. UG-100468.

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 ease of comparison, please refer to Illustration No. 3 below depicting these results for the Natural Gas Section:

Illustration No. 3:



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. In addition, over 24% (or $1.5 million) of the overall increase in requested revenue requirement is due to the additional Jackson Prairie storage facility inventory and O&M expense added to the Utility on May 1, 2011. Company witness Mr. Christie provides an overview of the Jackson Prairie natural gas storage facility within his testimony.

The total of the increased operating cost components requested in this case 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. Yes. 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 2010 operating results (twelve-months ended December 31, 2010) 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 an 8.23% rate of return. Column (f) reflects pro forma gas operating results with the requested increase of $6,207,000.

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

A. Yes. Page 2 shows the calculation of the $6,207,000 revenue requirement at the requested 8.23% rate of return.

Q. What does page 3 of Exhibit No._____(EMA-3) show?

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital calculation of 8.23%. Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

Q. Would you now please explain page 4 of Exhibit No._____(EMA-3)?

A. Yes. Page 4 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 5 through 9 of your Exhibit No._____(EMA-3), would you please explain what those pages show?

A. Yes. Page 5 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 5 and continue through column (w) on page 8[7]. Individual pro forma adjustments begin in column (PF1) on page 8 and continue through column (PF7) on page 9. The final column on page 9 is the total pro forma operating results and rate base for the test period.

[7] The restated total also includes an increase in expense and rate base necessary to annualize certain plant additions, which occurred in 2010, and includes a reduction to expense for a 6-year average of incentives.

<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 (w) are consistent with methodologies employed in our prior cases and current regulatory principles.

The first adjustment, column (c) on page 5, 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 $36,762,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the removal of the amortization expense included in the Company's 2010 test period related to Washington's portion of the amortized 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. The average of monthly averages (AMA) amount of the deferred gain for the 2012 rate period is zero. The use of AMA for the rate period was ordered in Order No. 01 in Docket No. U-071805. The effect on Washington rate base is a zero. The effect on Washington net operating income is an increase of $29,000.

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 $10,226,000.

The adjustment in column (f), 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 $31,000.

The adjustment in column (g), entitled **Customer Deposits,** deducts from natural gas rate base the average-of-monthly averages of customer deposits held by the Company, as ordered by this Commission in Docket UG-090135. The corresponding interest paid on customer deposits is reclassified to an operating expense, at the current UTC interest rate of 0.26%. The effect on Washington rate base is a decrease of $1,132,000. The effect on Washington net operating income is a decrease of $2,000.

The adjustment in column (h), **Restating 2010 Major Capital,** restates certain plant additions included in the test year on an AMA basis, together with the associated accumulated depreciation and deferred federal income taxes at a 2010 end of period basis, as described further by Mr. DeFelice. This adjustment includes the associated depreciation expense on the additions.

The 2010 natural gas capital additions that were annualized included the major distribution projects and the allocated portion of the one major general plant addition.

The effect of this adjustment on Washington net operating income is an increase of $55,000.[8] The effect on Washington rate base is an increase of $2,724,000.

Q. Please turn to page 6 and explain the first column shown there, and the adjustments that follow.

A. The first column on page 6 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.[9]

The first adjustment on page 6 in column (i), entitled **Revenue Normalization & Gas Cost Adjustment**, is an adjustment taking into account known and measurable changes that include revenue normalization (including the current authorized rates approved in Docket No. UG-100467), 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. Ms. Knox is sponsoring this adjustment. The effect

[8] During the process of completing the Company's filing the Company discovered an error in the natural gas Restating 2010 adjustment. The correct change in net operating income is an increase of $3,000, rather than the $55,000 noted above.

[9] This subtotal also includes an increase in expense and rate base necessary to annualize certain plant additions which occurred in 2010.

of this particular adjustment is to increase Washington net operating income by $3,300,000.

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 $3,000.

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 decrease Washington net operating income by $9,000.

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 $110,000.

The adjustment in column (m), entitled **Regulatory Expense Adjustment**, restates recorded 2010 regulatory expense to reflect the UTC assessment rates applied to revenues for the test period. The effect of this adjustment is to increase Washington net operating income by $86,000.

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 increase Washington net operating income by $107,000.

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

A. The first adjustment on page 7 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 increase Washington net operating income by $11,000.

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 2001 and 2010. This restating adjustment is made as a result of the Commission's Order in Docket No. UG-050483 and consistent with UG-100468. The effect of this adjustment is to increase Washington net operating income by $3,000.

The adjustment in column (q), **Eliminate A/R Expenses**, removes expenses incurred associated with the fees charged the Company for its customer accounts receivable program. The Company's accounts receivable program was terminated in December 2010. The effect of this adjustment is to increase Washington net operating income by $25,000.

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 our last general rate case in Docket No. UG-100468. 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 increase Washington net operating income by $62,000.

The adjustment in column (t), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, dues and donations, etc., included in error in the test period actual results, and removes or restates other expenses incorrectly charged between service and or jurisdiction totaling approximately $34,000.[10] I describe further the process for removing or restating certain expenses from the Company's test period in Section VII (Compliance with Commission Order No. 7) discussed below.

The Company also removed 50% of director meeting expenses, as ordered in Docket No. UE-090135, and 10% of director fees totaling approximately $22,000. Lastly, this adjustment removes Washington's natural gas portion of consulting services from the test period to reduce the revenue requirement requested in this case, totaling approximately $422,000. The effect of this adjustment is to increase Washington net operating income by $310,000.

The adjustment in column (u), **Restating Incentives,** restates the actual incentives included in the Company's test period using a six-year average adjusted by the Consumer Price

[10] Includes removal of Buck-A-Block program expenses (explained in the Electric Section above) allocated to gas.

Index. I discuss further in Section VII (Compliance with Commission Order No. 7) the basis for the use of a six-year average. The effect of this adjustment is to increase Washington net operating income by $352,000.

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

A The first adjustment on page 8, column (v), **Weatherization & DSM Investment Amortization Removal,** removes the amortization expense included in the test period due to the completion of the weatherization and DSM investment rate base being fully amortized in 2010. The effect of this adjustment is to increase Washington net operating income by $91,000.

The adjustment in column (w), **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. As applied to Washington's pro forma level of rate base, it 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 $5,000.

The next column on page 8, entitled **Restated Total**, subtotals all the preceding columns (b) through column (w), excluding the 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.[11]

[11] The restated total also includes an increase in expense and rate base necessary to annualize certain major plant additions which occurred in 2010, and includes a reduction to expense for a 6-year average of incentives.

Pro Forma Adjustments

Q. Please explain the significance of the 7 columns starting on page 9 of your Exhibit No._____(EMA-3).

A. The adjustments starting on page 9 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 provide an explanation of these adjustments shown on page 9.

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 adjustment PF2. For non-union employees, test period wages and salaries are restated to include the March 2011 overall actual increase of 2.8%, and 10 months of the planned March 2012 increase of 2.5%. Ms. Feltes discusses the Company's overall compensation plan and notes that the 2.5% minimum increase was presented to the Compensation Committee of the Board of Directors and was approved at the Board's May 2011 meeting.

Also included in this adjustment are the 2011 and 2012 union contract increases agreed to in 2010 of 3% for both years. The methodology behind this adjustment is consistent with that used in Docket No. UE-100468. The effect of this adjustment on Washington net operating income is a decrease of $357,000.

The adjustment in column (PF2), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating executive compensation test period salary expense to actual salary levels at 2011. This adjustment takes into account changes in compensation for the executive team in 2011. This adjustment reflects an annual increase for the actual overall 2011 officer increase of 3.79%. 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, based on survey of each executive. The methodology behind this adjustment is consistent with what was approved in Docket No. UG-090135. The impact of this adjustment on Washington net operating income is a decrease of $6,000.

The adjustment in column (PF3), **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 $296,000.

The adjustment in Column (PF4), **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 2011. Costs of system-wide insurance policies for 2011 varied only slightly from those policies in 2010. Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. In addition, Avista has removed a total of 10% of the total Directors' and Officers' insurance expense as ordered in Docket No. UG-090135. This adjustment increases Washington net operating income by $28,000.

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

A. The adjustment in column (PF5), **Pro Forma Survey & Replacement Programs**, pro forms additional capital and incremental operating and maintenance labor expense related to survey and replacement programs starting in 2011. The Company is implementing a special cathodic protection program for the purpose of finding and addressing isolated steel in its natural gas piping systems. This adjustment was made under the direction of Company witness Mr. Kopczynski and is described further in his testimony. This adjustment decreases Washington net operating income by $241,000 and increases rate base by $595,000

The adjustment in column (PF6), **Pro Forma JP Storage 2011**, pro forms expenses, capital investment and inventory for the increased storage capacity and deliverability associated with the transfer of a portion of the Jackson Prairie (JP) Storage facility to the Utility on May 1, 2011. Assets with a net book value of approximately $11.6 million transferred to the Utility on May 1, 2011, comprised of approximately $5.9 million of cushion gas and approximately $5.7 million of fixed assets. The increase related to the additional plant, and the accounting treatment of the JP cushion gas recorded in both recoverable and non-recoverable FERC accounts was approved in Docket No. UG-100468, Order No. 7, Settlement Stipulation, page 12, section III.5 (r).

Washington's share of these assets on a 2011 average-of-monthly-average basis increases net rate base by approximately $3.9 million. The adjustment also includes a rate base increase of $7.3 million for the working gas and recoverable cushion gas inventory associated with the additional storage. In addition, underground storage expense increased for the additional operating, depreciation and property taxes expense by approximately $473,000. The details of this adjustment can be found within my workpapers included with the Company's filing. The impact of this adjustment decreases Washington net operating income by $307,000 and increases rate base by $11,066,000.

The adjustment in Column (PF7), **Pro Forma Atmospheric Testing**, adjusts the test period expense for Atmospheric Corrosion expense. This is an inspection program to find conditions in the Company's system that could lead to corrosion issues on customer meter sets. This program is a federally-mandated program that requires the Company to inspect all above ground steel pipe at a frequency not to exceed three-years. This expense is on a three-year rotation between the Company's jurisdictions (Washington, Idaho, and Oregon) and is therefore, coded directly to Washington operations for the year in which the inspection occurs (2012 for Washington estimated at a total cost of $450,000). The Company is proposing to collect one-third of these costs over a three-year basis (2012-2014), and, therefore, has pro formed $150,000 for atmospheric O&M expense. The Company has received approval of this accounting treatment in its Oregon jurisdiction and will be requesting this treatment in the Company's next Idaho general rate case as well, so the Company remains whole on an annual basis. This adjustment was made under the direction of Mr. Kopczynski and is described further in his testimony. This adjustment decreases Washington net operating income by $97,000.

The last column on page 9, **Pro Forma Total**, reflects total pro forma results of operations and rate base consisting of twelve-months ended December 31, 2010 actual results and the total of all normalizing, restating and pro forma adjustments.

Q. Referring back to page 1, line 44, 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 4.41%. The pro forma rate of return is 6.31% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.23% 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 8.23% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $3,857,000, as shown on line 5, page 2 of Exhibit No._____(EMA-3). The resulting revenue requirement is shown on line 7 and amounts to $6,207,000, or an increase of 4.00% 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-100467 and UG-100468?

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 annually updated allocation factors used in this case have been provided with my workpapers.

VI. DEFERRED ACCOUNTING REQUEST FOR THE VARIABILITY IN GENERATING PLANT OPERATION AND MAINTENANCE COSTS

Q. Would you please explain the Company's request for deferred accounting associated with the variability in operation and maintenance costs related to its two major thermal generating plants?

A. Yes. The Company is proposing to defer changes in operation and maintenance costs related to its Coyote Springs 2 (CS2) natural gas-fired generating plant located near Boardman, Oregon, and its 15 percent ownership share of the Colstrip 3 & 4 coal-fired generating plants located in southeastern Montana. Both the Coyote Springs 2 and Colstrip 3 & 4 plants have schedules where major maintenance is to be performed.

The Company is requesting deferred treatment for these two plants specifically (CS2 and Colstrip) because major maintenance is scheduled every third or fourth year, providing large cost swings for these plants in any given year. This fluctuation in maintenance costs is typically not experienced by the Company's other hydro operating facilities or its Kettle Falls generating plant. For example, each unit at Colstrip has a regularly scheduled overhaul every third year. Since we have two units, this means that two out of every three years will have a scheduled maintenance outage and its associated costs. Whereas the maintenance interval at Coyote Springs 2 is based on hours of operation. We schedule these major outages in accordance with Original Equipment Manufacturer (OEM) guidelines on wear patterns and cycles for key plant equipment.

Therefore, depending on when the outages for each of these plants fall, we can have as much as two scheduled outages in one year or no scheduled outages, providing the potential for large cost fluctuations on a year-to-year basis. Unexpected outages also cause costs to fluctuate as more costs are incurred to repair the plant. However, in an unexpected outage situation, we may on a case-by-case basis have instances where operation and maintenance expense may actually be lower than authorized, as a portion of the repair costs are likely to be capitalized. The use of deferred accounting would smooth out these costs.

Q. Do other utilities that operate in Washington use deferred accounting similar to that proposed by Avista?

A. Yes. In Docket UE-090704, Order 11, *Puget Sound Energy Inc.*(PSE), paragraphs 162-163, the Commission approved PSE's request for deferred accounting treatment of O&M costs for certain generating plants for recovery in its next general rate case. PSE had proposed that deferred costs that are approved in future rate cases be amortized over five-years with the unamortized balance included in rate base as a regulatory asset.[12]

Q. How would the proposed deferred accounting work?

A. The Company would compare actual, non-fuel, operation and maintenance expenses for the Coyote Springs 2 and Colstrip 3 & 4 plants to the amount of expenses authorized for recovery in its last general rate case, and defer the difference from that currently authorized. The deferral would occur annually, with a carrying charge, with deferred costs being amortized over a three-year period, beginning in January of the year following the period costs are deferred. The comparison of actual to authorized costs would use the combined costs from the Coyote Springs 2 and Colstrip 3 & 4 plants. The reason for combining costs is to allow for the possibility that there might be lower than authorized costs from one plant that would offset higher than authorized costs from another plant in a given year.

Q. Why are you including both operation and maintenance expenses rather than just maintenance expense?

A. Operation and maintenance expenses are combined to take into account that during times of major maintenance, operation expense will decline, while maintenance expense will increase. By including both operation and maintenance expense, the decline in operation expense may partially offset the increase in maintenance expense.

Q. Would you please explain how the Company proposes to account for the deferred operations and maintenance expenses?

A. Pursuant to WAC 480-07-370(1)(b), the Company requests to defer the operations and maintenance expenses referenced above in Account 182.3 – Other Regulatory Assets. The deferrals will be allocated to the Washington and Idaho jurisdictions based on the Production/Transmission allocation in place at the time the deferrals are made, and placed in separate Washington and Idaho sub-accounts. Account 182.3 – Other Regulatory Assets would be debited, and Account 407.4 - Regulatory Credits would be credited as the deferrals are recorded. Amortization would be recorded by debiting Account 407.3 – Regulatory Debits, and crediting Account 182.3 – Other Regulatory Assets. Interest would accrue on the Washington share of the deferrals, net of deferred federal income tax, at the Company's weighted cost of debt, updated and compounded semi-annually.

Q. What is the amount of actual, non-fuel, operations and maintenance costs for the Coyote Springs 2 and Colstrip 3 & 4 plants included in the 2010 test period?

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[12] Docket No. UE-090704, Washington Utilities and Transportation Commission v. Puget Sound Energy, paragraph 158.

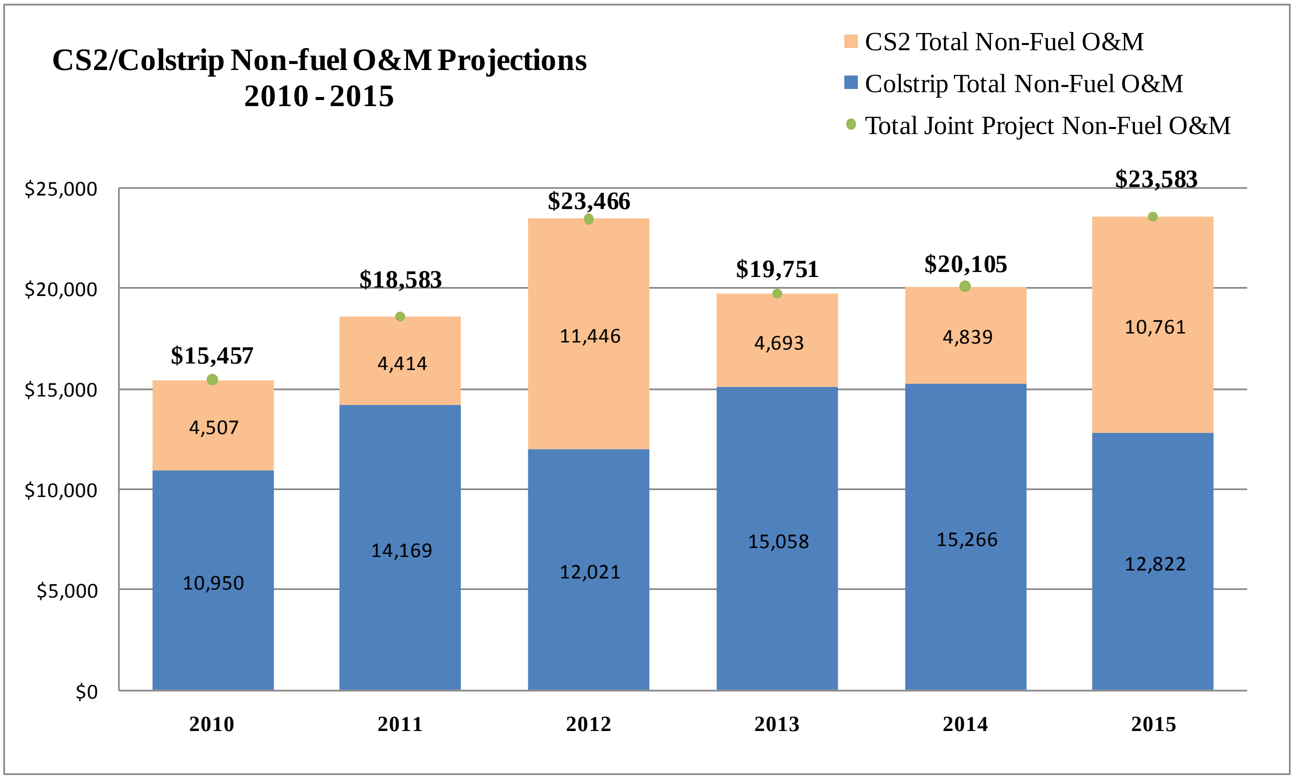
A. The amount of actual, non-fuel, operations and maintenance costs for the 2010 test period for the indicated plants is shown below (millions):

Coyote Springs 2	$ 4.5
Colstrip 3 & 4	$11.0
Total	$15.5

Q. What is the forecast of operation and maintenance costs for the Coyote Springs 2 and Colstrip 3 &4 plants?

A. The following Illustration No. 4 shows the forecast of non-fuel, operations and maintenance costs for the plants separately, and in total, for the five-year period of 2011 through 2015, as well as the actual costs for the 2010 test period. The forecast shows major maintenance occurring for Coyote Springs 2 in 2012 and 2015, and for Colstrip 3 & 4 occurring in 2013 and 2014.

Illustration No. 4



Q. What amount of non-fuel, operation and maintenance expense for Coyote Springs 2 and Colstrip 3 & 4 should be included for recovery in a general rate case?

A. The amount of expense to be included for recovery in a general rate case should be the actual O&M expense recorded in the test period, excluding any amount deferred during the test period, plus the amortization of previously deferred costs in the test period.

Q. Why is it not appropriate to use a historic average of operation and maintenance costs for the thermal plants to determine the amount of expense to be included for recovery in a general rate case?

A. The previous bar chart illustrates the variability in operations and maintenance costs for the thermal plants, and the upward trend in costs. The Company expects these costs to rise as the plants age, and as parts and labor become more expensive. Use of a historic average would likely understate the level of costs that the Company will experience in the future. A historic average can also be impacted by limiting, or expanding, the number of years used in computing the average, depending on the annual amounts of costs that have previously been incurred.

Q. Has the Company included or pro formed any additional O&M expense in this case for 2012 above that included in the 2010 test period?

A. No. Although the Company is anticipating incurring this additional expense during the 2012 rate period, this additional expense has not been included in the Company's case.

Q. Why did the Company choose a three-year amortization period?

A. A three-year amortization period was chosen as a reasonable recovery period since spikes in operations and maintenance expenses can occur every three to five years. For example, the Company's Colstrip units have outages two out of three years, however, the CS2 unit, based on hours typically dictates an outage every forth year. The three-year amortization period would generally fully amortize the costs of major maintenance of a unit, prior to the major maintenance occurring again for the same unit.

VII. COMPLIANCE WITH COMMISSION ORDER NO. 7, DOCKET NOS. UE-100467 & UG-100468

Appropriateness & Normalization of Incentive Costs

Q. Order No. 7, approving the Settlement Stipulation, in Docket Nos. UE-100467 and UG-100468, at page 8, stated "The Company will review its non-executive incentive compensation programs and provide testimony in its next general rate case: (1) identifying, explaining, and to the extent possible, quantifying the programs' benefit(s) to ratepayers; and, (2) explaining how the programs comply with the Commission's Final Orders in previous Avista general rate cases, specifically Dockets UE-991606[13] and UE-090134[14]. Please discuss Avista's perspective on these issues.

A. Company witness Ms. Feltes' direct testimony, discusses at length the Company's employee incentive program, specifically identifying, explaining, and quantifying the program's benefits to ratepayers. (Exhibit No.__(KSF-1T)

Ms. Feltes also explains how Avista's current incentive plan was designed in 2002, the goal of which was to focus on three key elements: cost control, customer satisfaction and the reliability of the energy we provide to our customers.

The Company has excluded all incentive target payouts that are not specifically related to reliability, customer service and operational efficiency targets, i.e., the earnings per share portion of officer incentive plan are excluded from utility expenditures.

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[13] In its Third Supplemental Order, Docket Nos. UE-991606 and UG-991607 (consolidated), ¶¶ 268-73*WUTC v. Avista Corporation, d/b/a Avista Utilities*, the Commission disallowed certain costs tied to financial performance and found that the incentive program was not tied to ratepayer benefit.

[14] In its Order No. 10 in Docket Nos. UE-090134 and UG-090135, the Commission directed the Company and all interested parties to review the employee incentive program for a more thorough evaluation of how the incremental cost of employee incentives should be treated in rates, and whether these costs should be normalized.

Based on the information provided by Ms. Feltes, there is evidence to support the appropriateness of including in rates the cost of the Company's incentive plan expenses because there is a benefit to our customers from a plan that specifically focuses on the three key elements discussed above: cost control, customer satisfaction and the reliability of the energy we provide to our customers.

Q. In the past several Avista rate cases has there been opposition to including the incentive program expenses that were included in the Company's test period, and ultimately recovering those in customer rates?

A. No, there has not. And in fact, the test period level of expenses related to O&M incentive payouts was included in the Company's approved revenue requirement in each case since the 2005 gas general rate case (GRC) (utilizing a 2003 test period), with the exception of the 2007 GRC discussed below. (See Docket Nos. UG-041515, UE-050482; UG-050483; UE-080416; UG-080417; UE-090134; UG-090135; UE-100467 and UG-1004968). As part of a settlement in the 2007 GRC (Docket Nos. UE-070804 and UG-070805) the Commission approved a level of incentive amount based on an average of several years, as proposed by Staff.

However, although the inclusion of the current incentive plan expenses has not been opposed for inclusion in the Company's rates collected from customers over the past several cases, there has been disagreement between the parties over the use of, or calculation of, an average or normalization of incentive expenses since the 2007 electric and gas GRCs. In addition, in Docket No. 090134, paragraph 129, the Commission requested that "... if the cost of incentives is appropriate to include in rates, parties should also explain whether these costs should be normalized."

Q. Please describe the 2007 GRC incentive average used and ultimately approved in that case.

A. In the Company's 2007 general rate case settlement agreed to by the parties and ultimately approved by this Commission (Docket Nos. UE-070804 and UG-070805), a form of average (or levelizing) as proposed by Staff was utilized which resulted in a decrease to the Company's originally requested revenue requirement. Staff witness Mr. Kermode, at page 23, lines 5-14, of his testimony (Exhibit No. 69 (DPK-1T) in that docket stated as follows:

> The Incentive payout from 1999 to 2006 varied from $0 to $5,864,642, according to the Company's response to Staff Data Request #232 -Supplemental. Avista did not pay any incentive payout during two out of the past eight years. It is my opinion that the test year's higher than normal incentive compensation should not be included in the company's results of operations used to determine rates but, rather, a levelized expense should be used instead. ….. I levelized the high and low incentive payouts by averaging the past eight years of incentive payouts.

Q. Does the Company believe that an average or normalization of incentive expense is appropriate for setting customer rates?

A. Yes. Since annual Company incentive plan payouts can often vary year-to-year, the Company continues to believe an average of annual payouts is most appropriate in order to "normalize" these costs. Often where there are revenues or expenses that can vary significantly from year-to-year, the Commission has approved averages to properly reflect a fair and reasonable level of revenue or expense to be included in customers' rates. Utilizing a six-year average of the Company's incentive plan payouts is consistent with other averaging methods utilized by this Commission in past proceedings. For example, as shown in the table below using the years 2005 through 2010, one can see the large variability that can occur in each year in payout, and therefore the variability in customer rates if an average was not utilized, and the impact of the six-year average as proposed in this case:

Illustration No. 5

Six-Year Average of Incentive Plan Payout	
*6-Year Average - 2010 GRC (Millions)	
2005	$6.2
2006	$4.7
2007	$3.4
2008	$2.9
2009	$5.1
2010	$9.4
6-Yr Average	$5.3
Test Year Incentive Exp.	$9.4
Restating Adjustment	($4.1)
**Includes payroll taxes and adjustment for CPI*	

In this instance, the table above reflects a restating reduction to test period expense of $4.1 million, showing a significant fluctuation in the level of expense between periods supporting the argument that use of an averaging methodology is appropriate.

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

A. There are several examples of revenue or expense amounts which have been averaged or normalized and approved by this Commission. First, the Company has used a five-year average for OASIS wheeling revenues because these revenues vary year to year depending on electric energy market conditions. Avista has, in 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 revenues. 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.

A third example includes the calculation of injuries and damages expense, which 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. Other examples of expenses where this Commission has approved the use of averages include power plant availability and storm damages.

Q. Briefly explain the reasoning behind the use of the CPI to adjust the average incentive level.

A. Incentive compensation is based on employees salary levels at the time of payout. These salary levels increase over time. If one does not adjust the historical years' expenses so that they are based on a similar level of salaries as that used in the test period, when the calculation is computed to determine the average, one is not using comparable levels of expenses in order to get to an "apples to apples" comparison.

Q. Did the Company include an adjustment for a six-year average in this current case?

A. Yes. For this filing, Avista has adjusted the actual level of incentive expense for the 2010 test period in its rate request, to reflect a six-year average, thus reducing its electric and natural gas revenue requirement by approximately $2,039,000 and $566,000 respectively. The Company continues to believe that the use of an average would be the most appropriate method to determine incentives for ratemaking purposes. The Company proposes that the Commission approve the use of a six-year average for incentive expense, and include this adjustment in the ultimate outcome of this case.

Company Review of Optional Renewable "Buck-A-Block" Power Rate Program

Q. Order No. 7, approving the Settlement Stipulation, required Avista to perform an internal review of its Optional Renewable Power Rate Program (Buck-A-Block), produce a report describing the accounting for all costs associated with the program (to be provided to all parties prior to its next general rate case), and track the costs associated with the review and development of the report. Has the Company fulfilled these requirements?

A. Yes, Avista has completed its internal review of the Company's Buck-A-Block program. Issues addressed and documented within the summary report included an accounting review of the program, a breakdown of 2010 actual program costs allocable to Washington, and the cost of performing this internal review. This summary report "Review of Accounting Procedures Relating to Optional Renewable Power Rate Program" is included as Exhibit No.__(EMA-4). This summary report, including attachments, was provided to all parties on March 24, 2011. The non-incremental labor cost of performing this internal review and preparing the summary report totaled approximately $3,600.

Q. Order No. 7 also stated that going forward Avista would account for all Buck-A-Block program costs separate from other Utility operations. Has this separate accounting treatment been completed at this time?

A. Yes. The required changes to the accounting process for the Buck-A-block program were implemented and became effective in July of 2010. However, as noted in the summary report, January through June 2010 activity still impacted 2010 test period Washington results of operations, requiring an adjustment to electric and natural gas results within the Company's test period results included in this case. The result of these adjustments increased electric expense by $11,500, and reduced natural gas expense by $2,300. Workpapers detailing these adjustments have been included in my workpapers provided with the Company's filing. (See Revenue Normalizing Adjustment (electric) and Miscellaneous Adjustment (natural gas)).

Company Review of Accounting Policies and Procedures

Q. Order No. 7, approving the Settlement Stipulation, required Avista to undertake, among other things, a review of its accounting policies and procedures, an additional internal audit of certain accounting policies, additional training of employees related to costs properly charged to utility customers, and produce a report discussing each, to be provided to all parties prior to the Company's next general rate case. Has the Company fulfilled these requirements?

A. Yes. Avista has completed its review of its accounting policies and procedures, the additional internal audit, and additional training of employees related to costs properly charged to utility customers. The findings resulting from this work were summarized in the Company's "Internal Review of Accounting Practices" report included as Exhibit No.__(EMA-5). Included as attachments to this report (and included in Exhibit No.__(EMA-5), are the materials developed related to this work, including the Regulatory Accounting Guidelines and

Policies Manual, Internal Audit's "Accounting Practices Audit" and "LIRAP Accounting Practices Audit" reports, and training materials. This report, including its attachments, was provided to all parties on May 12, 2011.

Q. As ordered, did the Company track the costs of fulfilling these requirements, and if so, how much were the overall costs?

A. The overall costs to complete the review of the Company's accounting policies and guidelines, the internal audit, training and materials, and the production of the final summary report, totaled approximately $102,700. However, the majority of these costs were for non-incremental Company labor, labor that would have been charged elsewhere if not for this project. The only incremental costs were approximately $2,660 for consulting services for the production of the accounting policy training video now available to employees.

Q. The Internal Audit Department completed its audit of 2010 expenditure transactions in March of 2011. Could you please summarize the audit findings and explain how the Company responded to these findings?

A. Yes. The Company's Internal Audit (IA) Department performed an internal audit of calendar year 2010 Utility expenditure transactions included in FERC accounts 400-935. The total population of transactions was just under 584,000 transactions (including revenues and expenses, debits and credits, between accounts 400-935). The population sampled totaled 301 transactions, totaling $537,167. The findings of this audit resulted in 21 transaction errors of approximately $5,302, which were found to be incorrectly charged to the Utility or between service and jurisdiction. The majority of these errors (20) were found within the FERC account range 900-935, commonly referred to as A&G accounts. The total of these errors were removed from the Company's test period prior to determining its final electric and natural gas revenue requirements requested in this case.

In addition, the IA Department also completed an audit of the Company's Low Income Rate Assistance Program (LIRAP) expenditures, reviewing tariff rider revenues, allocation of revenues to Community Action Agencies, and expense transactions that occurred during the calendar year 2010. The findings of this audit resulted in 9 errors, totaling $2,320 of internal labor incorrectly charged to the LIRAP program[15]. The Company has removed these transactions, as well as an additional $21,111 of additional internal labor, effectively removing all internal labor expenses charged to the LIRAP program in error.

Q. As noted above, the majority of the errors (20) found within the Utility expenditure audit were found within the A&G accounts (900-935). The errors identified specific to this range, totaling $4,757, were from a sampling of a larger population of all A&G expense transactions totaling approximately $47 million. Is it possible to extrapolate this error amount to the larger population to infer a total possible error from this total population of transactions?

A. No, it is not. As stated in the IA report, (see Exhibit No.__(EMA-5), page 50), "As we performed an attribute sampling plan to determine the frequency of errors, materiality and dollar values were not taken into consideration. Further, as the allocations between service and jurisdiction vary, the dollar value of the errors in the population may also offset each other. Therefore, dollar value extrapolation of errors across the population is not feasible."

[15] The audit revealed one employee had inadvertently been charging the LIRAP program for internal labor in error.

Q. How then can this Commission be assured that the Company has removed or corrected for errors outside of the audit sampling performed by the Company's IA Department?

A. The Company completed an extensive review if its 2010 expenses included in its test period, removing expenses found to be charged to the Utility in error, or inaccurately allocated to the Washington electric and natural gas jurisdictions. This review resulted in the removal of approximately $215,000 electric and $34,000 natural gas expenses from the Company's test period results, charged to the Utility in error (for costs related to dues, donations, sponsorships, miscellaneous employee expenses, non-utility airplane travel usage, etc.), as well as the reallocation of costs to properly reflect the correct service and jurisdiction of certain Washington electric and natural gas expenditures. The detail of these adjustments can be found within my workpapers labeled "Miscellaneous Adjustment" provided with the company's filing. (Please note that the Company, in previous cases, also had an adjustment to remove improper expense items known to it.)

Going forward, although the Company cannot guarantee that errors for these types of costs or expenses will never occur (given the universe of 584,000 accounting transaction between accounts 400-935), in May 2011 the Company completed its Company-wide employee training on the Company's accounting policies and guidelines for certain affected employees, educating these employees on the appropriate use of FERC accounts, proper use of expense descriptions, certain new and existing accounting policies, and utility versus non-utility expenditures. In addition, the Company will send to all employees semiannually a written reminder to employees to properly label and record expenditures, (including appropriate utility/non-utility, service and jurisdictional allocations), the first of which was sent to all employees in May 2011.

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

A. Yes, it does.