

**BEFORE THE WASHINGTON STATE  
UTILITIES AND TRANSPORTATION COMMISSION**

In Re: Investigation of Possible  
Ratemaking Mechanisms to Address  
Utility Earnings Attrition

DOCKET U-150040

INITIAL COMMENTS OF  
PUBLIC COUNSEL

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Appendix A: The History of Attrition Allowances in Washington

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## I. INTRODUCTION

1. Public Counsel appreciates the opportunity to work with other parties and the Commission Staff on the important questions which are presented for investigation in this docket. As a threshold matter, it is Public Counsel's view that Washington's approach to utility ratemaking, most recently reflected in the Commission decision in Pacific Power's 2014 General Rate Case (GRC),<sup>1</sup> continues to offer the most fundamentally sound basis for establishing fair, just, reasonable and sufficient rates, compared with the available alternatives.
2. The Commission and the state's regulated utilities are not currently facing urgent economic challenges, particularly when compared to past eras, such as the energy crisis of the 1970s, the high inflation of the 1980s, the Western Energy Crisis of 2000-2001, or the Great Recession. The economy is recovering, load growth is low, borrowing and capital costs are at record lows and have been declining, and inflation is not significant. Under these circumstances, the need for the Commission to abandon time-tested principles, carefully developed over many decades, upheld by the courts, and applied in many different economic conditions and periods of technological change, is not immediately apparent.
3. In general, the proposals being brought forward by industry in the recent past involve basing rates on less reliable information, more accelerated cost recovery, and movement towards more certain guarantees of earning the authorized rate of return. These types of proposals shift economic risk and burden to captive customers who rely on the monopoly utility for a service essential to business and domestic life. Existing ratemaking mechanisms, by contrast protect

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<sup>1</sup> *WUTC v. Pacific Power & Light Co.*, Dockets UE-140762 *et al.*, Order 08 (March 25, 2015) (Pacific Power 2014 GRC).

customers and advance the public interest by maintaining a fair balance between ratepayer and shareholder interests. Regulated utilities have the burden to show that they have a compelling need for alternatives.

## II. COMMENTS

### A. Causes of Attrition

**Notice:** Your organization's perspective on the causes of utility's earnings attrition e.g., high inflation, aggressive capital investment in infrastructure, low/no load growth.

#### 1. Attrition defined.

4. Before addressing causes of attrition, it is useful first to discuss the definition of "attrition." According to Professor Phillips, attrition is "the term frequently used to describe the eroding effects which increased costs caused by inflation have upon the rate of return of a utility, which must apply fixed rates for its services."<sup>2</sup> The term has been applied to circumstances where a utility's expenses grow faster than its revenues.<sup>3</sup> In the 2010 Decoupling Policy Statement issued by Commission, attrition is defined as "[t]he year-to-year decline in a utility's earnings caused by increased costs which are not offset by increases in rates and sales."<sup>4</sup> The Commission has described attrition as a "complex phenomenon which results from an unbalanced growth in revenues, expenses, and/or rate base that causes a change in the rate of return from its authorized level."<sup>5</sup>

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<sup>2</sup> Charles F. Phillips, Jr., *The Regulation of Public Utilities* 407 (3rd Ed., Public Utilities Reports, Inc., 1993) (Phillips). Attrition is addressed in the section of the text discussing "Earnings Erosion During Periods of Inflation." *Id.* at 402-408.

<sup>3</sup> *WUTC v. Washington Water Power Co.*, Docket No. U-82-10 *et al.*, Order No. 02, 62; *WUTC v. Pacific Power & Light Co.*, Docket No. U-83-33, Order No.02, 59-60.; *WUTC v. Washington Water Power Co.*, Docket No. U-83-26, Order No. 05, 47.

<sup>4</sup> *In the Matter of the WUTC's Investigation into Energy Conservation Incentives: Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets*, Docket U-100522, App. 7.

<sup>5</sup> *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-85-53, Order No. 02, 579.

5. In Puget Sound Energy’s (PSE) 2011 General Rate Case, the Commission stated that “[t]he formal definition of ‘attrition’ in the context of utility ratemaking is limited to circumstances in which key assumptions that underlie ratemaking theory fail to hold in reality . . . . ratemaking rests on the key assumption that the test-period relationships will accurately represent relationships in the future. If this assumption fails . . . rates approved based on test period conditions may not be adequate to achieve the allowed level of return under future conditions.”<sup>6</sup>
  
6. Commission Staff member Kenneth Elgin defined attrition in his testimony in the PSE 2011 GRC. What he called “negative” attrition is “the erosion of a company’s rate of return over time when the historical test period relationship in revenues, expenses and rate base accepted by the Commission in a rate case does not hold during a future rate year.”<sup>7</sup>
  
7. The Commission defined attrition similarly to Mr. Elgin in 1986 by stating, “Attrition is the change in relationships between revenues, expenses and rate base that is expected to occur in the future time period after rates based on the historic pro forma test period are in effect.”<sup>8</sup> The change in relationships among the revenues, expenses and rate base in which the growth in expenses exceeds the growth in revenues must be from “factors beyond the company’s control.”<sup>9</sup> The Commission has also defined the term attrition as “the circumstances where the rate base of

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<sup>6</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048/UG-111049, Order No. 08 ¶ 490 (PSE 2011 GRC). Because PSE did not request an attrition adjustment in the case, the Commission did not make a ruling on the issue. The Commission order, however, contains a general discussion of the issue of under-earning, and lists a range of regulatory responses. *Id.* ¶¶ 483-491. Options listed are: (1) pro-forma adjustments for known and measurable post-test-year costs; (2) end-of-test-year rate base; (3) CWIP; (4) comprehensive attrition allowance based on an attrition study; and (5) upward adjustment to equity share.

<sup>7</sup> *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-111048/UG-111049, Testimony of Kenneth Elgin, Exh. No. KLE-1T at 64.

<sup>8</sup> *WUTC v. Pacific Power and Light Co.*, Docket No. U-86-02, Order No. 02, 1986 Wash. UTC LEXIS 7, 47.

<sup>9</sup> *WUTC v. Washington Natural Gas Co.*, Docket No. UG-920840, Order No. 04, 1993 WL 500058, 19.

a utility grows faster than its net operating income after consideration of all pro forma and restating adjustments.”<sup>10</sup>

**2. Attrition compared to regulatory lag.**

8. The term “attrition” is not synonymous with term “regulatory lag.” Regulatory lag is a phenomenon that, in general, is simply an intrinsic characteristic of traditional rate base/rate of return regulation. Regulatory lag can affect either investors or ratepayers, and its effect is dependent on the length of time between rate cases. Regulatory lag can clearly have a salutary effect. As Professor Phillips observes: “Perhaps the most significant incentive to efficiency is regulatory lag.”<sup>11</sup> Maintaining efficiency incentives for utility ownership is essential, since the goal of monopoly regulation is to act as a substitute for competition. In a competitive market, competitive pressures compel management efficiencies as firms seek ways to reduce costs, to maximize profits, and to increase sales. Professor Bonbright in fact has described regulatory lag, often labeled as a deficiency of economic regulation, as the saving grace of regulation, rescuing it from acting as a force of mediocrity.<sup>12</sup>

9. The mere existence of regulatory lag is not a justification, in and of itself, for adoption of an attrition adjustment or other alternative ratemaking mechanisms. Likewise, the fact that revenues, expenses, and rate base change during the course of the rate year, an inevitable reality for any business, does not in and of itself necessitate a departure from standard ratemaking requirements and protections. It is important to recall that regulation does not guarantee, and is

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<sup>10</sup> *WUTC v. Washington Water Power Co.*, Docket No. U-84-28, Order No. 02, 1985 Wash. UTC LEXIS 88, 38.

<sup>11</sup> Phillips, at 401.

<sup>12</sup> Phillips, at 401; James C. Bonbright, *Principles of Public Utility Rates* 53-54 (Columbia University Press, 1961).

not intended to guarantee a profit to investors,<sup>13</sup> just as no competitive firm has such a guarantee. Nevertheless, much of the advocacy for alternative ratemaking appears to stem from an implicit assumption that Washington's regulatory framework is flawed unless it provides revenue stability, immediate cost recovery, and a guarantee of earning the authorized return.

**3. A Brief History of Attrition Allowances in Washington.**

10. Over the last several decades, the Commission has addressed many of the questions raised in this Notice in substantial detail under varying conditions for different companies. A review of these decisions provides valuable insights into the experience and principles that can help guide the discussion in this docket. A memorandum reviewing the cases is attached as Appendix A. This section summarizes the history.

11. As detailed in Appendix A, the Commission rejected a number of requests for attrition adjustments during the 1970s that departed from historic test period analysis in various ways, including use of end-of-period rate base. It appears that the first time that the Commission allowed an attrition adjustment was in a 1981 general rate case filed by Washington Water Power Company (WWP), Avista's predecessor.<sup>14</sup> Adopting the recommendations of Staff, the Commission authorized an attrition adjustment in the 1981 WWP proceeding to reflect rate year predicted revenues, expense and rate base levels. The Commission was specifically concerned about WWP's financial integrity and ability to raise capital at reasonable rates when it broke from its prior precedent, which consisted of routinely limiting utility rate development to use of historic test years with traditional restating and pro forma adjustments.

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<sup>13</sup> *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1180-81 (D.C. Cir. 1987) (*en banc*).

<sup>14</sup> *WUTC v. The Washington Water Power Co.*, Cause No. U-81-16, Second Supplemental Order, 1981 Wash. UTC Lexis 3 (November 25, 1981).



12. For a period of years during the 1980s, the Commission at times accepted, and at times rejected, both Staff and company proposals to incorporate an attrition adjustment in the development of various Washington regulated utility companies' requests for base rate relief. As a general matter, attrition adjustments were allowed as one-time increases to revenue requirement. The Commission did not set out a specific "test" or formula in the orders addressing attrition requests in the 1980s. However, frequent references were made to the following conditions existing when attrition adjustments were accepted (or noted to be absent when attrition adjustments were rejected):

- High inflation
- High financing costs or interest rates— relative to embedded costs existing on the various companies' balance sheets at the time
- Large construction programs
- Vastly different rates of change in revenues, expenses, and rate base
- Deteriorating financial integrity – jeopardizing credit ratings and ability to economically finance needed construction

13. The last express attrition adjustment that the Commission approved was a 1986 Pacific Power and Light general rate case order.<sup>15</sup> Subsequent to that docket, the next time a Washington utility sought an attrition adjustment was in the Washington Natural Gas (WNG) 1992 general rate case. The Commission rejected WNG's attrition request, stating:

The Commission concludes that no attrition adjustment should be granted in this case. An adjustment for attrition is an extraordinary measure, not generally included in general rate relief. A request for attrition should be based on

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<sup>15</sup> *WUTC v. Pacific Power & Light Co.*, Cause No. U-86-02, Second Supplemental Order, 1986 Wash. UTC Lexis 7, 47-50.

extraordinary circumstances, not shown by the company to be present in this case.<sup>16</sup>

14. Subsequent to the Washington Natural Gas case just cited, no utility requested a specific attrition adjustment until Avista requested an attrition adjustment twenty years later in Dockets UE-120436 *et al.*<sup>17</sup> Attrition has been an issue in subsequent Avista rate cases, and also in the PSE Rate Plan dockets. However, in none of these recent decisions has the Commission yet had occasion to address attrition issues in detail.<sup>18</sup>

**4. Causes of attrition.**

15. As the Phillips text indicates, the most commonly recognized cause of attrition is high inflation.<sup>19</sup> As the review of Commission cases in Appendix A reflects, the Commission has identified the following as the primary causes of attrition sufficient to warrant an attrition adjustment: (1) high inflation; (2) high financing costs or interest rates – relative to embedded costs existing on the company balance sheet; (3) unusually large construction program; (4) vastly different rate of change in revenues, expenses and rate base; and (5) deteriorating financial integrity jeopardizing credit ratings and ability to economically finance necessary construction.

16. Low or no load growth does not by itself cause attrition. Absent significant cost increases resulting from high inflation and low growth should not necessarily result in earnings erosion. If a utility is experiencing low or no growth, all other things being equal, there would be no need for unusually high levels of capital expenditures to meet new load.

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<sup>16</sup> *WUTC v. Washington Natural Gas*, Docket No. UG-920840, Fourth Supplemental Order, 1993 WL500058, at 20 (September 27, 1993).

<sup>17</sup> PSE's 2006 request for a depreciation tracking mechanism, designed to address alleged earnings erosion, is discussed in Appendix A. The proposal was not adopted.

<sup>18</sup> Appendix A contains some additional detail regarding recent cases.

<sup>19</sup> Phillips, at 408 (referring to the attrition allowance as an "inflation adjustment").

17. Variations in earnings alone do not cause attrition. Variations in earnings may occur for many reasons and from many sources, however it is the sustained and continuing pattern of earnings erosion that produces attrition.<sup>20</sup>
18. In recent years, Washington utilities have most often cited high levels of capital expenditure as the chief factor justifying an attrition adjustment request. Companies frequently point to the need to replace aging infrastructure or to invest in new renewable resources as creating exceptional capital expenditure requirements. In an era of very low inflation, declining capital costs, and low load growth, however, there remains a heavy burden on the utility to show the need for an attrition allowance. This should include a showing that the causes of attrition are outside the control of the utility. Utilities have the ability to control when they will make capital expenditures to replace aging infrastructure, timing investments and rate requests to minimize regulatory lag. If a capital investment is placed into rate base in a timely fashion, absent high rates of inflation, or other extraordinary factors, there should be no need for an attrition adjustment or other special mechanisms, notwithstanding that aging infrastructure is being replaced or a renewable resource acquired.
19. The utility industry has been replacing aging infrastructure for a century or more, as well as investing in new resources. Existing legal parameters and regulatory methodologies have over many decades allowed these investments to be placed in rate base if prudent, and authorized the return of and return on investment in rates. The burden should be on the utility asking for special rate treatment outside this framework to make a persuasive evidentiary showing that it faces

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<sup>20</sup> Vol. I, Robert L. Hahne, Gregory E. Aliff and Deloitte and Touche LLP, *Accounting for Public Utilities* 8-4 to 8-5 (LexisNexis, 2009). Attrition is addressed generally in Chapter 8 of the text.

serious financial detriment. There should be no presumption that earnings erosion attrition is occurring or that an attrition adjustment of some type is warranted. As with any other rate increase, the burden of proof is on the utility to prove its need for additional revenue.

**5. The purpose of attrition adjustments.**

20. The Commission has stated that the purpose of an attrition adjustment is to remedy situations where the company is “experiencing *vastly* different rates of change in revenues, expenses, and rate base” than what the rates were based upon.<sup>21</sup> It goes without saying that revenues, expenses, and rate base are all constantly changing as part of ordinary ongoing utility business operations. The function of regulation is not to eliminate the effect of these changes. If that were accomplished, the utility would become a risk-free business, unlike any business in the competitive market place. From Public Counsel’s perspective this investigation should focus on addressing unusual circumstances that pose special threats to utility financial health. The fact that utilities face business risk, including fluctuations in costs and revenues, is not a compelling reason to alter fundamental ratemaking principles.

21. While the Commission has stated that failure to adjust for attrition when the company is experiencing “vastly different rates of change” would “amount to a refusal to allow the company a reasonable opportunity to earn its allowed rate of return,”<sup>22</sup> it has also made clear that an attrition allowance, is not designed to guarantee that the company earns its rate of return. Instead, the attrition adjustment is a mechanism “designed to improve the likelihood that a utility has a true opportunity to earn its allowed rate of return.”<sup>23</sup> An attrition adjustment “is an

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<sup>21</sup> *WUTC v. Washington Water Power Co.*, Docket No. U-82-10 *et al.*, Order No. 02, 1982 Wash. UTC LEXIS 3, 54 (emphasis added).

<sup>22</sup> *Id.*

<sup>23</sup> *WUTC v. Pacific Power & Light Co.*, Docket No. U-84-65, Order No.04, 68 P.U.R. 4<sup>th</sup> 396, 426.

extraordinary measure, not generally included in general rate relief. A request for such an adjustment should be based on extraordinary circumstances . . . .<sup>24</sup>

**B. Public Counsel's Preferred Ratemaking Mechanisms to Address Regulatory Lag or Earnings Erosion**

**Notice: Your organization's preferred ratemaking mechanism(s) for addressing each of the forms of earnings attrition identified in (1) above including benefits and shortcomings of your preferred mechanism and alternative mechanisms. Discuss whether alternative causes of attrition require different ratemaking solutions.**

**1. Public Counsel's preferred alternative ratemaking mechanisms.**

22. In recent cases, Public Counsel has supported regulatory mechanisms that are preferable to an attrition adjustment to address concerns about earnings erosion and/or regulatory lag.

These include:

1. End of period valuation of rate base
2. Pro forma adjustments to reflect post-test year plant additions
3. Pro forma expense adjustments that capture post-test year increases that can be verified and measured
4. The Expedited Rate Filing (ERF) mechanism

These mechanisms have previously been identified and employed by the Commission as tools to address earnings erosion and regulatory lag and are generally understood in Washington. Public Counsel is prepared to address these in more detail, as appropriate, as the proceeding progresses. In particular, it would be useful in this docket to develop more clear parameters for the ERF mechanism.

<sup>24</sup> *WUTC v. Washington Natural Gas Co.*, Docket No. UG-920840, Order No. 04, 1993 WL 500058, 20.

**2. Benefits/shortcomings of Public Counsel's proposed alternatives.**

23. Public Counsel's preferred mechanisms reduce regulatory lag or attrition, if a Company can provide persuasive evidence of serious earnings erosion. As a general matter, these alternatives rely upon actual and verifiable costs. They thus avoid the subjectivity, ambiguities, and difficulty of verification associated with attrition adjustments. Because they can be used within the existing ratemaking framework, they are more straightforward and efficiently employed than a full-blown attrition case.

24. Arguably, the fact that these alternatives may not fully eliminate regulatory lag could be seen by some parties as a shortcoming. However, because regulatory lag provides a valuable incentive for utilities to operate efficiently and control costs, it is actually beneficial that some degree of lag remain in the system.

**3. Benefits/shortcomings of an attrition adjustment/allowance.**

25. An attrition adjustment can benefit a utility by providing an infusion of revenue and eliminating or reducing financial risk. Attrition adjustments have a number of serious shortcomings, however. First and foremost, attrition adjustments place substantial reliance on cost projections rather than on actual costs. A cornerstone of establishing fair, just, reasonable, and sufficient rates is that they are based on actual, verifiable, auditable, known and measurable costs. Company projections of costs have never been treated as a reliable foundation for setting rates in Washington, except in extraordinary circumstances.<sup>25</sup>

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<sup>25</sup> *WUTC v. Puget Sound Energy*, Dockets UE-090704/UG-090705, Order 11 ¶ 29 (PSE 2009 GRC) (even adjustments that become known and measurable more than a few months after the test year are "inherently suspect").

26. A second major drawback of an attrition adjustment is the negative effect on management's incentive to manage costs.<sup>26</sup> If future revenues are guaranteed, management loses motivation to control expenses so as to maximize returns. In this regard, approval of an attrition allowance is antithetical to the role of regulation as a surrogate for competition. In an effectively competitive market, a company is not able to set prices so as to guarantee a specific profit margin for its investors during some future time period. Regulation is not intended to facilitate such an approach by a monopoly utility provider.

27. Third, to the extent an attrition adjustment is based on a projected high level of capital expenditures, an attrition allowance may have the perverse effect of encouraging unnecessary or premature capital expenditures in order fulfill the projections made in the most recent rate proceeding. Commission Staff pointed out this issue in the most recent Avista GRC.<sup>27</sup>

28. Finally, the calculation of an attrition allowance poses significant methodological problems. Unlike the field of public utility accounting in general, and ratemaking methodology specifically, there are no generally accepted procedures for developing an attrition adjustment. Development of attrition adjustments varies from case to case, company to company, and commission to commission. A range of issues can arise that the regulator must resolve, including:

- What historic time periods should be used for trending analysis?
- What historic cost of service components should be examined?

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<sup>26</sup> Public Counsel's preferred mechanisms also reduce efficiency incentives to some degree, but not to the extent of a broad attrition adjustment used as a full replacement for a revenue requirement case.

<sup>27</sup> *WUTC v. Avista Corp.*, Dockets UE-140188/UG-140189, Testimony of David C. Gomez, Exh. No. DCG-ITC at 16-17 (Avista 2014 GRC).

- To what extent is budgeted information used, and to what extent combined with historic?
- Should time periods and data used for different cost components be matched?
- Should cost components be grouped into buckets? If so, how many, and how are costs allocated to the buckets?
- How are capital costs trended or considered?
- To what extent is trending an appropriate tool to use with rate base, which is characterized by “lumpiness”?

All of these factors can render review of an attrition request a complex and contentious process. The problems of constructing an appropriate attrition analysis are discussed further in Section D below.

**4. Do alternative causes of attrition require different ratemaking solutions?**

29. As a theoretical matter, it is possible to characterize attrition differently based upon the underlying cause, as noted by Professor Phillips:

A regulated utility may encounter such increasing costs in securing capital (capital cost attrition), in adding new plant to service at incrementally higher per unit costs (rate base attrition), or in the operating expenses normally incurred to provide services (NOI attrition).<sup>28</sup>

30. Different approaches may be appropriate for different situations. Identification of the specific factor causing the erosion can allow narrow targeting of a remedy. For example, if rate base attrition is identified, use of the “end-of-period” rate base would be more appropriate than a full projected revenue requirement approach.



31. In examining any company request for relief from earnings erosion, it is important to review the mechanisms already in place to provide more timely cost recovery for a particular company. A company that has in place a purchased gas adjustment (PGA), a power cost adjustment (PCA), a full decoupling mechanism, and additional trackers and deferred accounting mechanisms may not be able to credibly establish a need for additional special regulatory relief. All of these mechanisms are designed to address causes of earnings erosion or revenue instability.

### C. Historical Test Year

**Notice: If your organization prefers the Commission to adhere to a historical test year ratemaking approach, discuss why it would or would not be appropriate to consider potential earnings attrition in that historical test year context.**

32. Public Counsel recommends that the Commission continue to employ the modified historical (or “hybrid”) test year approach. The Commission strongly reaffirmed this approach in two well-reasoned and thorough decisions for the State’s two largest investor-owned utilities, PSE<sup>29</sup> and Avista,<sup>30</sup> and did so again this week in the Pacific Power 2014 GRC Order. It remains the most reliable way to set fair rates because it is the most closely tied to actual costs.

33. Public Counsel’s preferred alternative mechanisms for addressing earnings erosion all can be used in the context of a modified historical test year ratemaking framework. Indeed, this is a significant advantage of this approach, since it does not require inventing a new set of regulatory parameters.

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<sup>29</sup> *WUTC v. Puget Sound Energy, Inc.*, Order 11 ¶¶ 22-35 (April 2, 2010) (PSE 2009 GRC).

<sup>30</sup> *WUTC v. Avista Corp.*, Dockets UE-090134/UG-090135 & UG-060518, Order 10 ¶¶ 40-52 (December 22, 2009).

**D. Requirements and Parameters for Public Counsel Preferred Mechanisms.**

**Notice: If your organization has a preferred mechanism(s), please discuss the requirements and parameters necessary for calculating the adjustments.**

34. As discussed in Section B, Public Counsel's preferred mechanisms to address earnings attrition include the following regulatory tools: end-of-period valuation of rate base, a post-historic test year adjustment to "update" the valuation of major plant-related rate base components closer to the rate effective date, pro forma expense adjustments that capture post-test year increase that can be verified and measured, and an Expedited Rate Filing (ERF) mechanism. The parameters and requirements necessary for calculating these adjustments are described in the direct testimony of James Dittmer, Exhibit No. JRD-1T, in Dockets UE-140188/UG-140189, attached to this testimony as Appendix B.<sup>31</sup>

**1. Should an attrition analysis include historical data only?**

35. One of the inherent complexities of an attrition adjustment is the open-ended nature of the analysis used to develop the adjustment. Recent attrition adjustments proposed by utilities have utilized a "mix and match" approach where a historical trend period is used to develop escalators for certain categories of costs, while budgets were used for others. Still other categories of costs were escalated simply on the judgment of the utility. These proposals have also relied on varying time periods to develop historical and forecast escalation factors. This disjointed approach is problematic because it allows any party to propose any number of historic

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<sup>31</sup> For a discussion of the end-of-period rate base and post-historic test year adjustment to update the valuation of major plant-related rate base components see pages 42-43 of Exh. No. JRD-1T; for a discussion of pro forma expense adjustments that capture post test year increases that can be measured and verified see pages 67-74 of Exh. No. JRD-1T; for a discussion of the use of an ERF to address earnings attrition see pages 48-56 of Exh. No. JRD-1T; for a discussion of pro forma adjustments to reflect post-test year plant additions, see pages 58-59 of Exh. No. JRD-1T.

periods and historic cost of service components to combine with various elements of budgeted information to develop a desired attrition adjustment.

36. A well-supported attrition analysis should be as free from subjectivity and manipulation as possible. Requiring an attrition analysis to include historical data only would avoid some of the complexity and opportunity for “cherry picking” described above.<sup>32</sup> However, subjectivity around the time periods used to develop the historic escalation rates would remain. One solution to address this issue would be to require escalation factors for all cost categories to be based on consistent time periods and consistent data (either budgeted or historical). However, there are challenges with this approach because the same historical periods might not be accurate cost predictors for different categories of costs.

37. As a result of the complexities and inherent subjectivity of attrition adjustments as well as other concerns, Public Counsel has recommended, and continues to recommend, alternative approaches other than an attrition adjustment to address earnings attrition.

## **2. Should rate-year capital budgets be considered?**

38. A key concern in the development of an attrition methodology is that the analysis be free from subjectivity. There may be cases where it is appropriate for capital budgets to be considered in developing an escalation factor for a certain category of costs, however, the inherent subjectivity of this determination is problematic.

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<sup>32</sup> Public Counsel believes it is generally preferable to develop escalation factors off of known, historical data as opposed to budgeted data which by its nature is subjective and uncertain. However, there are concerns with relying strictly on historical data to develop an attrition adjustment as well. Historic cost trends are not always reliable predictors of future events and conditions. Costs can fluctuate over time as a result of higher or lower inflation and changes customer growth. Breakthroughs in technology can also impact cost trends, as can investments made to reduce future operating expenses. For example, a utility might invest in a technology with the assumption that the investment could avoid future operating costs. An attrition adjustment based upon historical average cost trends may not capture this offset. *See*: Testimony of James R. Dittmer, Exh. No. JRD-1T, at 32-33, Dockets UE-120436, *et al.*

**3. Should there be a bright-line cut-off date for including pro forma plant in rate base?**

39. Public Counsel supports the use of selected pro forma adjustments as one tool to address earnings attrition. In the 2013 PacifiCorp General Rate Case, Public Counsel supported the Commission Staff's recommendation for a bright-line cut-off with respect to major plant additions. Public Counsel argued that such an approach would allow for greater certainty for the utility and its ratepayers.<sup>33</sup> The Commission's order in that case, as well as in the recent Pacific Power 2014 GRC order, rejected the concept of a bright-line cut-off date for including pro forma plant in rate base in favor of a flexible, case-by-case determination.<sup>34</sup> Given the Commission's recent reiteration of its approach on this issue, Public Counsel supports the determination of pro forma adjustments on a case-by-case basis, applying the "known and measurable" and "used and useful" standards, and requiring identification of customer benefit.

**4. What level of precision should be expected for projected capital budgets (budgeted to actual) for ratemaking?**

40. Public Counsel shares the concern in this area raised by Commission Staff in the Avista 2014 GRC with regard to capital expenditure projections. Staff witness David Gomez points out a number of factors that make it difficult to test the accuracy of company projections of capital additions, including the extent of backlogged or delayed projects. Staff also points out that projections may become a "self-fulfilling prophecy" where there is an incentive for rates of capital expenditure to be driven by an effort to match earlier projections.<sup>35</sup>

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<sup>33</sup> *WUTC v. Pacific Power & Light Co.*, Docket UE-130043, Amended Brief of Public Counsel ¶ 43 (October 15, 2013).

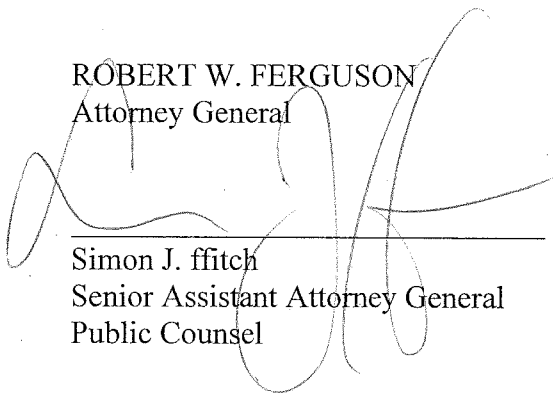
<sup>34</sup> *WUTC v. Pacific Power & Light Co.*, Docket UE-130043, Order 05 ¶¶ 198-200; Pacific Power 2014 GRC, Order 08 ¶¶ 165-172 (December 4, 2013).

<sup>35</sup> Avista 2014 GRC, Dockets UE-140188/UG-140149, Testimony of David C. Gomez, Exh. No. DCG-1TC.

### III. CONCLUSION

41. Public Counsel looks forward to participating further in this investigation and engaging with other parties and the Commission Staff to help establish guidance on these issues, and balanced policies for future ratemaking proceedings.
42. DATED this 27<sup>th</sup> day of March, 2014.

ROBERT W. FERGUSON  
Attorney General



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Simon J. Ffitch  
Senior Assistant Attorney General  
Public Counsel

## APPENDIX A

### THE HISTORY OF ATTRITION ALLOWANCES IN WASHINGTON

#### A. Economic Conditions in the 1970s and 1980s.

In 1973 and 1979, the United States experienced two oil shocks. As a result, the 1970s marked the end of the Post-World War II era of high growth rates and full employment with various periods of high inflation, low growth, and high unemployment.<sup>1</sup> Cheap oil, the driving force of the world's economy, became more expensive in the 1970s when Middle Eastern producers seized control of their oil resources from the oil companies and pushed prices "to what were considered stratospheric levels."<sup>2</sup> The high price of oil was reflected directly in higher prices for gasoline, home heating oil, fuel oil, and any other product directly connected to oil.<sup>3</sup> The high oil costs caused consumers to use considerably less energy.<sup>4</sup>

Taken together, the slowed demand for energy, high interest rates and stratospheric energy prices created many problems for the energy industry. The industry "far overestimated its needs in the 1970s" and thus in the late 1970s and early 1980s, many utility companies were unwilling and, in some cases, financially unable to build new plants due to uncertain demand combined with soaring fuel and construction costs.<sup>5</sup> Furthermore, those companies that were heavily involved with nuclear plant construction were severely harmed in the wake of the Three Mile Island accident.<sup>6</sup> During this time, utilities and regulators sought solutions, such as attrition

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This memorandum is based on an internal Public Counsel research paper.

<sup>1</sup> Daniel Yergin, *Awaiting the Next Oil Crisis*, N.Y. Times, July 11, 1982, at 18.

<sup>2</sup> Douglas Martin, *Energy Shortage Eases Materially; Basic Shifts in Consumption Cited*, N.Y. Times, March 8, 1982, at A1.

<sup>3</sup> Yergin at 6.

<sup>4</sup> Martin at 1.

<sup>5</sup> Robert D. Hershey, *Power Industry's Uncertainty*, N.Y. Times, May 22, 1984, at D1.

<sup>6</sup> *Id.* at D1.

adjustments, to help combat the problems of high inflation, high construction costs and the utilities inability to attract capital for construction of new plants.<sup>7</sup>

### **B. Attrition Adjustments in the 1970s.**

Early requests for attrition adjustments from Washington utilities in the 1970s were dominated by discussions centering on the proper methodology to calculate an attrition adjustment. The Washington Utilities and Transportation Commission (WUTC or Commission) consistently affirmed the pro forma test-year approach, also known as a historic test-year, as “fundamental”<sup>8</sup> in determining revenue deficiencies because “selection of an actual test year permits review of company records by the Staff representatives not otherwise possible if an abstractly constructed year or estimated future year were utilized in the rate making process.”<sup>9</sup>

In November of 1973, Puget Sound Power and Light Company filed revisions to its tariff seeking a general increase in its charges and rates for electric service by \$23,339,600.<sup>10</sup> At issue was the company’s proposal of a year-end rate base versus the accepted average rate base calculation.<sup>11</sup> The Commission noted that it historically had accepted the average rate base concept as the appropriate tool to measure the earning level. Only where “special conditions exist,” where the conventional manner of adjusting for expansion and rising costs on a prospective basis are insufficient, would it consider using the year-end rate base concept.<sup>12</sup> The Commission held the criteria for a year-end rate base were not met.<sup>13</sup> The Commission found that Puget’s inability to achieve the anticipated rate of return was due to the Centralia steam plant

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<sup>7</sup> *Id.* at D1.

<sup>8</sup> *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-73-57, Order No. 04, 7 P.U.R.4th 44, 48.

<sup>9</sup> *Id.* at 49.

<sup>10</sup> *Id.* at 48.

<sup>11</sup> *Id.* at 50.

<sup>12</sup> *Id.* at 50.

<sup>13</sup> *Id.* at 52.

injecting higher unit costs of production along with inflationary impacts that impaired the company's ability to absorb "wage and sundry" expense increases.<sup>14</sup>

The following year, in November of 1974, The Washington Water Power Company also brought a challenge to the historical pro forma test-year approach. The company initially presented evidence supporting its tariff revision for electrical service with data that utilized both actual and projected results of company operation for 1973 and 1974.<sup>15</sup> The Commission rejected this presentation and stated, "[t]he historical concepts of pro forma results of operation are well supported, and should be the procedure utilized in this case; therefore, the projected basis should be rejected."<sup>16</sup>

Also in November of 1974, Pacific Power and Light Company filed a general rate increase for electric service utilizing a projection for 1974. The company argued that "during times of high inflation and great demand for expansion of electric service, the use of the historic test-year period by the Commission is outmoded."<sup>17</sup> The company contended that historic test-periods were time-consuming, impaired the ability of the utility to finance electric service, and that costs and revenues should have been calculated closer to the time that the rates would have gone into effect.<sup>18</sup> The Commission remained "committed to the proposition that the historic test-year period is best utilized for rate making."<sup>19</sup> Quoting extensively from Cause U-73-57, the Commission "affirmed the pro forma-test year approach as the overall best and fundamental approach appropriate for determining rate deficiency."<sup>20</sup> In fact, the Commission ordered the company to refile its case using a historic test-year period. The company complied

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<sup>14</sup> *Id.* at 51.

<sup>15</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-74-4, Order No. 02, 1974 Wash. UTC LEXIS, 53.

<sup>16</sup> *Id.* at 54.

<sup>17</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-74-8, Order No. 3, 7 P.U.R.4th 470, 475.

<sup>18</sup> *Id.* at 475-476.

<sup>19</sup> *Id.* at 476.

<sup>20</sup> *Id.* at 477.



but also included the projected 1974 test-year which the Commission once again set aside, reiterating “the commission adheres to the selected historical period chosen.”<sup>21</sup>

The Commission expressed concerns regarding attrition adjustments in Pacific Northwest Bell Telephone Company’s (PNB) request for a tariff increase in Cause U-74-14. PNB proposed an “earnings erosion adjustment” which the Commission found to be identical to an earlier “rate base attrition adjustment” proposed by PNB and rejected by the Commission in Cause U-72-30.<sup>22</sup> The Commission restated its previous concerns regarding attrition adjustments and inflation. The Commission stressed, “[i]nflation is a recognized fact of economic life and in setting rates for the future the inflationary impact is indeed recognized not only in the cost of plant but also in the increased cost of money required to produce new plants.”<sup>23</sup> The Commission continued by warning that accounting for inflation in an attrition adjustment could unfairly benefit investors reasoning that, “[i]nflation and the expectation of inflation must have influenced investors for the prices they paid for common stock and debt capital and the terms on which they were willing to invest their money.”<sup>24</sup> Moreover, the Commission stated that “the use of an attrition factor would amount to an unwarranted duplication and would in effect not only protect the equity investor against inflation, but would in fact make him a beneficiary thereof.”<sup>25</sup>

In 1978, Puget Sound Power and Light filed a general rate increase revision which included an attrition adjustment due to the effects of high inflation.<sup>26</sup> Once again, the issue of

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<sup>21</sup> *Id.* at 477.

<sup>22</sup> *WUTC v. Pac. Northwest Bell Telephone Co.*, Docket No. U-74-14, Order No. 02, 1975 Wash. UTC LEXIS 12, 31.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 32.

<sup>25</sup> *Id.*

<sup>26</sup> While some members of the public argued that no increase should be granted, others stated that given the effects of high rates of inflation, the company should be given a justifiable increase. *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-78-21, Order No. 02, 1979 Wash. UTC LEXIS 5, 15.

whether to set rates based on a historic pro forma test year or a future test year was before the Commission. The pro forma test year approach was preferred by the Commission because the historic test period is a “reliable and consistent basis for establishing rates in electric and other utility cases, because it presents a comparison of actual results of operations for a specified period with actual rate base values outstanding for the same period.”<sup>27</sup> The future test year was rejected by the Commission because a forecasted rate year is a “composite of estimates of events, revenues and expenditures” and “these events cannot be precisely calculated from present data.”<sup>28</sup>

As these cases show, the Commission in the 1970s consistently mandated usage of a pro forma historic test-year when setting rates for public utilities. Additionally, the Commission rejected numerous company proposals that sought to stray from the historic test-year period such as year-end rate base calculations, projected future test-years and combinations of historic test-year periods with future projections.

### **C. Attrition Adjustments in the 1980s.**

The bulk of the Commission orders approving attrition adjustments for public utilities were issued in the early 1980s. In total, attrition adjustments were requested of the Commission at least 17 times from 1980 to 1986.<sup>29</sup>

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<sup>27</sup> *Id.* at 16.

<sup>28</sup> *Id.* at 32.

<sup>29</sup> In 1980, the Commission authorized interim rate relief for Puget Sound Power and Light Company due to the company’s financial condition; Moody’s Investor Service downgraded Puget from a P-2 to P-3 company and Puget was having a difficult time obtaining funds for construction. Of note for purposes of attrition analysis is the Commission’s continued stance that, “in evaluating a petition for interim rate relief it will not consider or give weight to long-range economic projections but that it will accept evidence of existing and actual conditions and short-range projections, which are the least subject to volatile economic winds and are more conducive to credible reliability than long-range plans.” Furthermore, the Commission stressed that “[we] do not regard a deteriorated overall rate of return as justification for authorizing interim rates; the area is only one of many areas of inquiry as to overall financial stability.” The Commission’s continued support for historic test-year periods and refusal to look solely at the rate of return to assess the financial condition of the utility in the interim rate relief context is consistent

Washington Natural Gas requested tariff revisions in Cause U-80-25 that were rejected by the Commission because the annual gross revenues sought would have produced a rate of return exceeding the proper rate.<sup>30</sup> Washington Natural Gas claimed that they were experiencing a post test-year loss of revenue due to declining use by customers<sup>31</sup> and thus, they argued for the adoption of year-end rate base calculations that employed a lead-lag method in computing working capital allowance compared to Staff's balance sheet approach.<sup>32</sup> The company contended that their revenues had consistently remained below levels allowed by the Commission in the seven rate orders issued since 1972 due to attrition from plant and operation costs rising more rapidly than revenues. The company also argued that a year-end rate base would mitigate attrition because year-end data more closely approximates post-rate-case conditions.<sup>33</sup>

Staff objected to the end-of-period approach arguing that fluctuations in the sources of revenue and expenses preclude a proper matching of recorded revenues at a single point in time.<sup>34</sup> The Commission once again upheld the historic test period over the end-of period approach agreeing with its Staff's concerns that a "point-in-time" rate base is not reliable. The Commission elaborated that this unreliability "fosters overstatement or understatement" of the revenue requirement and that "distortion of the revenue requirement in either direction leads to results which are contrary to the statutory requirement that rates be just, reasonable and sufficient."<sup>35</sup> Of note, the Commission did express concern for the utilities concerning regulatory lag and attrition and indicated that they "will be receptive in dealing with future cases

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with its decisions on attrition adjustments. *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-80-10, Order No. 02, 1980 Wash. UTC LEXIS 5, 7.

<sup>30</sup> *WUTC v. Wash. Natural Gas Co.*, Docket No. U-80-25, *et al.*, Order No. 04, 14.

<sup>31</sup> *Id.* at 3.

<sup>32</sup> *Id.* at 4.

<sup>33</sup> *Id.* at 5.

<sup>34</sup> *Id.* at 6.

<sup>35</sup> *Id.*

to well-reasoned, supportable mechanisms to address these concerns, recognizing that adoption of such mechanisms would require verifiable evidence of their validity and propriety.”<sup>36</sup>

In 1981, an attrition adjustment was approved for Washington Water Power Company in Cause U-81-15. The Commission viewed the attrition adjustment as warranted because “the company’s commitment to its construction projects to 1985, and its present program for major projects has created an imbalance in its ability to raise necessary construction funds from internal sources. This in turn has adversely affected the company’s financial indices, upon which investors rely in examining the company’s financial structure.”<sup>37</sup> The attrition adjustment was granted so that the company could preserve and maintain their financial integrity, allow it to generate cash flow for their construction projects, and to attract investors at a reasonable cost.<sup>38</sup> Moreover, the Commission stated that attrition adjustments should be viewed on a case-by-case basis only and that the evidence to support an attrition adjustment “must be of such a character that will lead us to a firm conviction that not to do otherwise will jeopardize the company’s financial integrity and adversely affect the ability of the company to render required service to its customer at reasonable rates.”<sup>39</sup> Lastly, granting the attrition adjustment, the Commission again explicitly rejected a projected test year in favor of the historical test year approach because, in comparison, the traditional approach was more reliable and more suited to intelligent examination and scrutiny upon which an informed judgment can be made.<sup>40</sup>

Also in 1981, however, the Commission rejected Pacific Power and Light’s requested attrition adjustment in Cause U-81-17. The company again presented a future projection in an

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<sup>36</sup> *Id.*

<sup>37</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-81-15, *et al.*, Order No. 02, 1981 Wash. UTC LEXIS 3, at 41-42.

<sup>38</sup> *Id.* at 42.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 11-12.

effort to mitigate the effects of attrition. This was rejected by the Commission because the historic rate base is a “reasonable approach to the problem while avoiding the potential for distortion and other infirmities inherent in the estimated future test period approach.”<sup>41</sup> The Commission also restated that attrition adjustments should be evaluated on a case-by-case basis.<sup>42</sup>

Puget Sound Power and Light Company’s request for an attrition adjustment in Cause U-81-41 was rejected by the Commission because they found that the company’s actual results of operations demonstrated that they were keeping pace with recent levels of inflation, were improving their operating results, and because economic measures undertaken by the federal government helped to control inflation.<sup>43</sup> In addition, the Commission indicated that Puget could make serious efforts at “improving efficiencies and at achieving economies in day-to-day operations” that could produce substantial results. In concluding the discussion of why the Commission rejected the company’s request for an attrition adjustment, the Commission declared, “we do believe that an attrition adjustment would tend to dampen management incentive to achieve efficiencies in staff and in use of other resources.”<sup>44</sup>

The next year, in Cause U-82-10, the Commission authorized an attrition allowance for Washington Water Power Company. The reason given for the requested attrition allowance was that the company was experiencing “vastly different rates of change in revenues, expenses and rate base” and “that a refusal to recognize this problem . . . would amount to a refusal to allow the company a reasonable opportunity to earn its allowed rate of return.”<sup>45</sup> Both People’s

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<sup>41</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-81-17, Order No. 02, 1981 Wash. UTC LEXIS 1, 6-7.

<sup>42</sup> *Id.* at 26.

<sup>43</sup> *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-81-41, Order No. 02, 45 P.U.R.4th 605, 642.

<sup>44</sup> *Id.*

<sup>45</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-82-10, *et al.*, Order No. 02, 1982 Wash. UTC LEXIS 3, 54.

Organization for Washington Energy Resources and Public Counsel opposed the attrition adjustment with Public Counsel unsuccessfully arguing that the state of the economy at the time and the financial plight of the customers of the utility were reasons to reject the attrition allowance.<sup>46</sup>

Pacific Power and Light Company was granted an attrition allowance in Cause U-82-12.<sup>47</sup> The Commission Staff and the company both supported the attrition allowance. The Commission, for the first time, gave the following detailed description of how to determine an appropriate attrition allowance:

The first step is to calculate results of operations after rate relief from the balance of the proceeding. Then, the revenues and costs are projected to the end of the attrition year . . . by use of the appropriate growth factors as specified above. Then the company's results of operations are calculated based on experience of the projected costs, and the attrition rate of return is subtracted from the authorized rate of return, as adjusted for weatherization allowances, producing a rate of return differential. The rate of return differential is multiplied by the attrition year rate base to produce the attrition net operating income required for the company to achieve its authorized rate of return. The net operating income requirement is converted to gross revenue by use of a conversion factor and then is discounted to the test year to account for the time value of money.<sup>48</sup>

In Cause U-82-19, the Commission granted an attrition allowance to Pacific Northwest Bell Telephone. Interestingly, the Commission favored the future test year model proposed by the company over the pro forma adjustments supplied by Staff. The Commission stated, "The Commission finds that the future test year introduced by respondent is a useful tool for measuring the earnings/attrition phenomenon and determining the appropriate adjustment thereafter."<sup>49</sup> This is the only example found of a future test year being accepted by the

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<sup>46</sup> *Id.*

<sup>47</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-82-12, *et al.*, Order No. 04, 1983 Wash UTC LEXIS 65, 64.

<sup>48</sup> *Id.* at 63.

<sup>49</sup> *WUTC v. Pac. Northwest Bell Telephone Co.*, Docket No. U-82-19, *et al.*, Order No. 02, 1983 Wash. UTC LEXIS 64, 46.

Commission; there are no known electric or gas utility examples where a future test year was used to calculate an attrition adjustment.

Puget Sound Power and Light Company was granted an attrition adjustment in Cause U-82-38. Puget had embarked on a massive construction project in the 1970s in order to meet projected load growth and replace hydropower purchase contracts that were set to expire.<sup>50</sup> During this time, the Commission observed that regulatory change, high inflation, social and environmental concerns, and lack of capital impeded Puget's ability to complete their construction program and all three nuclear projects they were involved with ran into significant problems.<sup>51</sup> The Commission was faced with a company that needed a bond rating of BBB in order to be able to retain reasonable access to capital markets. The Commission concluded that the company was in a weakened financial condition with significant construction projects underway and the need for a high degree of investor confidence in order to raise the necessary construction funds.<sup>52</sup> Based on these factors, the Commission authorized an attrition adjustment.<sup>53</sup>

The Washington Water Power Company was granted an attrition allowance in Cause U-83-26. Public Counsel objected to the attrition adjustment because of concerns that it was potentially duplicative of the operations adjustments and that it failed to provide the company with sufficient incentives for more efficient operations.<sup>54</sup> The Commission again affirmed its commitment to utilizing a historical test-year while explicitly rejecting the company's

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<sup>50</sup> *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-82-38, Order No. 03, 1983 Wash. UTC LEXIS 39, 3.

<sup>51</sup> *Id.* at 4.

<sup>52</sup> *Id.* at 7.

<sup>53</sup> *Id.* at 59.

<sup>54</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-83-26, Order No. 05, 1984 Wash. UTC LEXIS 69, 47-48.

Box-Jenkins analysis and trended growth rates.<sup>55</sup> A total additional attrition return of \$821,000 was granted to the company.<sup>56</sup> The Commission was explicit in its order that the decision was based on the Staff's historical trend analysis.<sup>57</sup> The Commission has consistently rejected future projections in determining attrition adjustments and, in fact, did so in Cause U-83-26 with the rejection of the predictive Box-Jenkins analysis.

In Cause U-83-27, the Commission approved a stipulation between Washington Natural Gas, Commission Staff and Public Counsel permitting an attrition allowance for the company.<sup>58</sup> The attrition allowance was intended to offset projected irregularities and growth rates.<sup>59</sup>

In Cause U-83-33, Pacific Power and Light Company proposed both an attrition adjustment and an alternate elasticity adjustment. The elasticity adjustment was based on a demand elasticity study to be used if the company's load forecast were not used for an attrition adjustment. The company abandoned both their attrition and elasticity studies in favor of Commission Staff's attrition analysis and adjustments of \$4,262,000.<sup>60</sup> This order did not explain why the company abandoned their attrition and elasticity adjustments. It may have been due to the fact that Staff's proposed attrition adjustment was nearly two million dollars more than the company's proposed adjustment. The Commission authorized the attrition allowance for \$3,967,000.<sup>61</sup>

In Cause U-84-28 the Commission rejected an attrition adjustment for the Washington Water Power Company. The Commission Staff opposed the attrition adjustment arguing it was

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<sup>55</sup> *Id.* at 48. In time series analysis, the Box–Jenkins methodology, named after the statisticians George Box and Gwilym Jenkins, applies autoregressive moving average ARMA or ARIMA models to find the best fit of a time series to past values of this time series, in order to make forecasts.

<sup>56</sup> *Id.* at 49.

<sup>57</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-83-26, Order No. 05, 1984 Wash. UTC LEXIS 69, 49.

<sup>58</sup> *WUTC v. Wash. Natural Gas Co.*, Docket No. U-83-27, Order No. 02, 1983 Wash. UTC LEXIS 21, 5.

<sup>59</sup> *Id.* at 12.

<sup>60</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-83-33, Order No. 02, 1984 Wash. UTC LEXIS 64, 60-61.

<sup>61</sup> *Id.* at 76.



not justified by the company's rates of return.<sup>62</sup> Public Counsel argued that an attrition allowance should be rejected because past Commission orders indicated that an attrition allowance was "an extraordinary measure to be used only when the absence of such an allowance would jeopardize the company's financial integrity and adversely affect the ability of the company to render required service to its customers at reasonable rates."<sup>63</sup> The Commission rejected the company's proposed attrition adjustment stating, "The company has the burden of proof to demonstrate that this extraordinary measure is necessary."<sup>64</sup> The Commission went on to state that the burden of proof was not met for an attrition adjustment because of the new climate of reduced inflation, the winding down of the company's previous large construction program, and the company's reduced debt financing and projections for revenue growth.<sup>65</sup>

In addition to rejecting the company's attrition request, the Commission rebuked the Commission Staff for not basing their opposition to the company's attrition adjustment on an actual attrition analysis of its own. The Commission warned, "[w]hile the burden of proof does not rest with the Commission Staff, the Commission would expect the Commission Staff to perform its own analyses in the future in the process of arriving at its proposals."<sup>66</sup> The attrition request was ultimately rejected because disallowance was not seen to prevent the company from earning their authorized rate of return.<sup>67</sup>

Pacific Power and Light was granted an attrition adjustment in Cause U-84-65 based on the testimony of Commission Staff witness Mr. Louiselle.<sup>68</sup> The Commission indicated that an attrition allowance "is designed to improve the likelihood that a utility has a true opportunity to

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<sup>62</sup> *WUTC v. Wash. Water Power Co.*, Docket No. U-84-28, Order No. 02, 1985 Wash. UTC LEXIS 88, 38.

<sup>63</sup> *Id.* at 39.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 40.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 66.

<sup>68</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-84-65, Order No. 04, 68 P.U.R.4th 396, 425.

earn its allowed rate of return.”<sup>69</sup> The company did propose an attrition study that combined “econometric forecasts, budgeted costs, and detailed function-by-function analyses.”<sup>70</sup> The Commission found the company study unpersuasive because where particular expenses declined, budgeted increases were factored into the projections for reasons which were unclear to the Commission.<sup>71</sup>

The negatives of an attrition adjustment were weighed against the positives with the Commission indicating that its “derivation requires a good deal of judgment” and “that the same reasons that cause the Commission to use a historic test year rather than a forecasted test year would weigh against the use of an attrition allowance.”<sup>72</sup> The Commission qualified its statement by pointing out that “[t]he attrition allowance, however, tends to be smaller in scope than a forecasted test year, and thus more manageable. It is of a limited nature and more susceptible of knowledgeable evaluation.”<sup>73</sup> The Commission again warned of the risk of double recovery due to “the extent that pro forma adjustments to historical data may be based in part on ‘estimates’ of future costs, and to the extent that inflation is already factored into the cost of equity . . . .”<sup>74</sup> Thus, the Commission cautions that “sound regulatory practice requires that the attrition allowance be used sparingly . . . only when doing so is necessary to avoid setting rates so low as to be confiscatory under the *Hope* and *Bluefield* tests. The Commission believes that attrition is no more nor less subject to the *Hope* and *Bluefield* tests.”<sup>75</sup> Ultimately, the

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<sup>69</sup> *Id.* at 426.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

Commission found that the attrition allowance was “reasonably required” even though the unusual levels of inflation previously experienced were no longer anticipated.<sup>76</sup>

Puget Sound Power and Light was granted an attrition allowance of \$11,409,000 in Cause U-85-53. This is the largest known attrition adjustment and was approved due to Puget’s plant and expense growth. Staff’s witness Mr. Louiselle criticized Puget’s attrition analysis as incomplete for failing to incorporate offsetting factors such as revenue growth.<sup>77</sup> Additionally, Mr. Louiselle argued that the company’s nuclear power plant at Satsop, Washington (WNP 3) should not be included in the attrition analysis.<sup>78</sup> The Commission accepted the Staff’s attrition adjustment and agreed that the WNP 3 costs should not be included as a part of the attrition adjustment.<sup>79</sup>

Cause U-86-02, Pacific Power rate request, is the last known rate increase based on attrition, prior to Avista’s recent requests, discussed below.<sup>80</sup> The company based its request on inflation, and fact that cost increases outpaced sales growth during the period that the rates would be in effect.<sup>81</sup> Public Counsel argued that attrition allowances were no longer necessary under the economic conditions of the time and that the company’s failure to earn an allowed rate of return could be attributable to many factors other than those which would justify an attrition allowance.<sup>82</sup> The Commission accepted the Staff’s attrition calculation, finding it more persuasive than the company’s because it took into account more recent changes in economic factors.<sup>83</sup> The Commission found the company’s attrition study to be flawed because “the DRI forecasts upon which the company’s attrition analysis were based had changed substantially

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<sup>76</sup> *Id.* at 427.

<sup>77</sup> *WUTC v. Puget Sound Power & Light Co.*, Docket No. U-85-53, Order No. 02, 74 P.U.R.4th 536, 580.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 581.

<sup>80</sup> *WUTC v. Pac. Power & Light Co.*, Docket No. U-86-02, Order No. 02, 1986 Wash. UTC LEXIS 7, 73.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 49.

<sup>83</sup> *Id.*

since the company ran the model. Despite those changes, the company did not rerun the model to reflect those changes.”<sup>84</sup>

#### **D. Attrition Adjustments after the 1980s.**

There are no known approved rate adjustments expressly tied to attrition in Washington State between 1986 and the 2012. The Commission rejected an attrition adjustment for Washington Natural Gas in cause UG-920840. The Commission Staff argued that the factors that may have justified an adjustment in the past such as declining gas sales, increasing gas prices, and high inflation no longer existed.<sup>85</sup> The Commission concluded that no attrition adjustment should be given and reiterated that “[a]n adjustment for attrition is an extraordinary measure, not generally included in general rate relief. A request for such an adjustment should be based on extraordinary circumstances, not shown by the company to be present in this case.”<sup>86</sup> Furthermore, the Commission noted that past attrition allowances were allowed “when the Commission found that, without such an adjustment, the company would have no reasonable opportunity to earn its authorized rate of return.”<sup>87</sup> Moreover, attrition adjustments were found to be unnecessary because the company already had an approved tracker mechanism to pass through changes in its cost of gas which further reduced the risk that attrition would have had a negative impact on the company’s ability to earn its rate of return.<sup>88</sup>

In Docket UE-060266, PSE proposed a new regulatory mechanism to track depreciation expenses for transmission and distribution investments between general rate cases. PSE argued

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<sup>84</sup> *Id.*

<sup>85</sup> *WUTC v. Wash. Natural Gas Co.*, Docket No. UG-920840, Order No. 04, 1993 WL 500058, 20.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

that it needed the depreciation tracker to address regulatory lag.<sup>89</sup> The Commission responded to this novel mechanism with a strong defense of fundamental ratemaking principles:

PSE undoubtedly recognizes regulatory lag is typical of rate base, rate of return ratemaking grounded in an historic test year adjusted for changes that are known and measurable at the end of that test year. Indeed, the circumstances of which PSE complains are simply an inherent part of the historic test period approach, which requires the application of certain fundamental ratemaking principles that we and many other regulators endeavor to apply consistently over time. In particular, we disfavor and typically avoid single-issue ratemaking and we are careful to preserve so far as reasonable the ‘matching principle’ that relies on our consideration of all revenues, costs, and adjustments in the context of a test year with an ending date . . . . It requires extraordinary circumstances to support a departure from fundamental ratemaking principles. In prior cases the Commission has required a clear and convincing showing that the company will be denied any reasonable opportunity to earn its authorized rate of return without extraordinary relief . . . . Our analysis of the evidence leaves us unpersuaded that PSE will suffer earnings attrition as a result of not recovering depreciation on infrastructure investments it makes between rate cases.<sup>90</sup>

#### **E. Recent Commission decisions related to attrition.**

In PSE’s 2011 GRC, in response to PSE’s claimed inability to earn its authorized rate of return in recent years, the Commission discussed attrition and reviewed a variety of mechanisms available to address under-earning, including: (1) pro-forma adjustments for post-test year expenses; (2) end-of-period rate base; (3) CWIP; (4) a comprehensive attrition adjustment for expenses, based on an attrition study; and (5) an upward adjustment to the equity share.<sup>91</sup> Also in that case, Staff proposed an Expedited Rate Filing (ERF) as an additional mechanism to assist in addressing its attrition. Staff’s ERF proposal envisioned that a utility would be permitted to make a rate filing, within a reasonable time after a GRC, that adhered to cost of capital, restating adjustments and class cost of service rate spreads and rate design adopted by the Commission in

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<sup>89</sup> *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-060266, *et al.*, Order No. 08, 255 P.U.R.4th 287, 299.

<sup>90</sup> *Id.* at 300.

<sup>91</sup> *WUTC v. Puget Sound Energy*, Dockets UE-111048/UG-111049, Order 08 ¶ 491 (May 7, 2011) (PSE 2011 GRC).

its most recent decision addressing such topics.<sup>92</sup> As there was no specific ERF proposal before it, however, the Commission made no specific determinations regarding the mechanism, but invited parties to give it further consideration.<sup>93</sup>

In Avista's 2012 GRC, the Company based its rate request on a significant attrition adjustment. All parties except Public Counsel entered into a "black box" settlement that expressly did not approve an attrition adjustment.<sup>94</sup> While the Commission concluded the settlement included amounts for attrition, the Commission's order specifically noted that it was not endorsing any specific attrition methodologies, assumptions or inputs.<sup>95</sup>

In early 2013, in PSE filed requested Rate Plan that included an Expedited Rate Filing, combined with a decoupling request, and a type of attrition adjustment based on a "K-factor" automatic rate escalator. The Commission order approving the Rate Plan did not extensively address specific attrition methodologies, assumptions, or inputs.<sup>96</sup>

In 2014, Avista based its 2014 General Rate Case on an attrition analysis which was contested by Public Counsel and Industrial Customers of NW Utilities (ICNU). The case resulted in a "black box" all-party settlement which did not include agreement on whether an attrition adjustment was included or appropriate. The parties did recommend that a separate forum be established to address attrition adjustments and related issues.<sup>97</sup> The Commission approved the settlement, which led to the initiation of the instant docket. Avista's 2015 General Rate Case, filed in February, is again based on an attrition analysis.<sup>98</sup>

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<sup>92</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 & UG-111049, Order 08 ¶ 507 (May 7, 2012).

<sup>93</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 & UG-111049, Order 08 ¶ 507 (May 7, 2012).

<sup>94</sup> *WUTC v. Avista Corp.*, Dockets UE-120436/UG-120437, *et al.*, Order 09 ¶ 33 (December 26, 2012).

<sup>95</sup> *Id.* ¶ 77.

<sup>96</sup> *WUTC v. Puget Sound Energy*, Dockets UE-121697/ UG-121705 & UE-130137/UG-130138, Order 07 (June 25, 2013) (PSE Rate Plan).

<sup>97</sup> *WUTC v. Avista Corp.*, Dockets UE-140188/UG-140189, Order 05 ¶¶ 48-51 (November 25, 2014).

<sup>98</sup> *WUTC v. Avista Corp.*, Dockets UE-150204/UG-150205.

**APPENDIX B**

BEFORE THE WASHINGTON  
UTILITIES & TRANSPORTATION COMMISSION

WUTC V. AVISTA  
DOCKETS UE-140188 & UG-140189

DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1CT)

ON BEHALF OF PUBLIC COUNSEL

REGARDING REVENUE REQUIREMENT

JULY 22, 2014

**REDACTED VERSION**

DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1CT)  
DOCKETS UE-140188 & UG-140189

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DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1CT)  
DOCKETS UE-140188 & UG-140189

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**EXHIBIT LIST**

Exhibit No. JRD-2	Summary of Public Counsel Electric Adjustments
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Exhibit No. JRD-4C	Response to Staff Data Request No. 92
Exhibit No. JRD-5C	Response to Public Counsel Data Request No. 22 (Attachment A is Confidential)
Exhibit No. JRD-6	Response to Public Counsel Data Request No. 136
Exhibit No. JRD-7	Response to Public Counsel Data Request No. 191
Exhibit No. JRD-8	Summary of Experience and Qualifications

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**I. INTRODUCTION**

**Q: Please state your name and address.**

A: My name is James R. Dittmer. My business address is Post Office Box 481934, Kansas City, Missouri 64148.

**Q: By whom are you employed and in what capacity?**

A: I am a Senior Regulatory Consultant with the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate work. The firm's engagements include review of utility rate applications on behalf of various federal, state and municipal governmental agencies as well as industrial groups. In addition to utility intervention work, the firm has been engaged to perform special studies for use in utility contract negotiations.

**Q: On whose behalf are you testifying?**

A: I have been retained by the Public Counsel Section of the Washington Attorney General's Office to primarily review, address and respond to Avista's proposal to reflect significant "attrition adjustments" in its recommended revenue requirement for its electric and natural gas operations. Additionally, I am addressing a limited number of more traditional "restating" and "proforma" adjustments to the historic test year ending June 30, 2013.

**Q: Please summarize your professional experience.**

A: My education and professional experience is summarized in Exhibit No. JRD-8.

**Q: What exhibits are you sponsoring in this proceeding?**

A: In addition to Exhibit No. JRD-8 that summarizes my educational and professional experience, I am sponsoring the following exhibits:



1       A:     As previously described, my primary charge and focus in this engagement was to  
2             review and respond to Avista’s proposed attrition adjustment. As a result of my  
3             review and analysis, I am proposing that Avista’s attrition adjustments be  
4             rejected. As shown by the evidence submitted herein, there are significant  
5             challenges to developing the methodology to employ an attrition adjustment that  
6             lead me to conclude that an attrition adjustment is not the best tool to address  
7             regulatory lag. Moreover, neither conditions precedent to the granting of an  
8             attrition adjustment, nor the guidelines to be adhered to when developing an  
9             attrition adjustment, have been vetted or established by this Commission. I  
10            submit that alternative approaches to addressing regulatory lag, potential earnings  
11            erosion, and work load and fatigue experienced by regular rate case participants  
12            resulting from frequent filing of general rate case, have not been fully explored  
13            and tried.

14                       Accordingly, as an alternative to adoption of an attrition adjustment, as a  
15                       means to address the noted concerns of regulatory lag, earnings erosion, and “rate  
16                       case fatigue,” I recommend the following mechanisms and approaches:

- 17                       • End of period – as opposed to the average-of-monthly-averages  
18                       valuation of major rate base components - should be adopted in  
19                       this proceeding.
- 20                       • A post-historic test year adjustment to “update” the valuation of  
21                       major plant-related rate base components closer to the rate  
22                       effective date should be adopted.

- 1                   • Pro forma expense adjustments that capture post-test year increases  
2                   that can be verified and measured should be adopted.
- 3                   • Avista should be permitted to undertake up to two Expedited Rate  
4                   Filings with relatively few constraints and restrictions that should  
5                   reduce regulatory lag as well as rate case participants’ work load.

6                   The post-test year updates to Net Plant Less Deferred Income Taxes  
7                   adjustments I am recommending are not insignificant. For electric  
8                   operations the post-test year plant update adjustment, calculated by  
9                   considering Public Counsel’s recommended cost of capital, increases  
10                  revenue requirements by approximately \$9.2 million. For gas operations,  
11                  the update adjustment increases revenue requirements by approximately  
12                  \$3.6 million.

13               **Q: Did you undertake a comprehensive analysis and review of Avista’s claimed**  
14               **revenue deficiency for its Washington jurisdictional electric and gas**  
15               **operations?**

16               A: No. As noted, my primary focus in this engagement was to review and respond to  
17               Company’s proposed attrition adjustments. While I attempted to broadly review a  
18               few other topical areas, resource constraints did not permit a complete or  
19               comprehensive review of all issue areas. Public Counsel may subsequently elect  
20               to support some of the adjustments of other parties in this proceeding. As a result,  
21               I am *not* proposing a comprehensive “bottom line” revenue requirement  
22               recommendation on behalf of Public Counsel.

1       **Q: Is Public Counsel presenting a cost of capital recommendation in this**  
2       **proceeding?**

3       A: Yes. Public Counsel has retained Mr. Stephen Hill to present a cost of capital  
4       recommendation in this proceeding. The total impact of all Public Counsel  
5       recommended adjustments relative to those proposed by Avista in this case,  
6       including Mr. Hill’s cost of capital recommendation, is \$45,386,000 for electric  
7       operations and \$6,998,000 for gas operations.

8       **Q: In addition to providing the overall base revenue requirement in this case,**  
9       **Avista also provides the “billed revenue change” which incorporates the**  
10       **expiration of rebates associated with the ERM and a BPA Settlement and the**  
11       **addition a proposed REC revenue rebate. Do you address these expiring and**  
12       **new credits?**

13       A: I am aware that Avista has reflected the impact of these expiring and new credits  
14       to its total base revenue increase in this case to determine the total net billing  
15       revenue change to customer rates. I do not take a position on the expiring rebates  
16       and the REC revenue rebate is addressed by Public Counsel witness Lea Fisher.

17                   **III. EXHIBIT NOS. JRD-2 AND JRD-3 ORGANIZATION**

18       **Q: Please explain how your schedules within Exhibit No. JRD-2 Summary of**  
19       **Public Counsel Electric Adjustments and Exhibit No. JRD-3 Summary of**  
20       **Public Counsel Gas Adjustments are organized.**

21       A: Schedule No. 1 of Exhibit No. JRD-2 and Exhibit No. JRD-3 consist of a  
22       Summary of Public Counsel Electric Adjustments and a Summary of Public  
23       Counsel Gas Adjustments, respectively. Also shown on each Schedule No. 1 is a

1 listing of every electric and gas adjustment incorporated within Avista’s original  
2 direct filing. Avista adjustments that I am not supporting, modifying or opposing  
3 within this direct testimony have a designation of “PC Neutral in Direct” noted on  
4 each Schedule No. 1 for electric and gas operations. As discussed earlier, it is  
5 possible that Public Counsel may adopt another party’s position regarding  
6 Company adjustments that I am not addressing within this testimony. For  
7 Company adjustments where Public Counsel is proposing an alternative  
8 calculation to that undertaken by the Company, such adjustments have been  
9 designated as “PC Modified.” There also several Company adjustments that  
10 Public Counsel is specifically opposing. Those adjustments have been designated  
11 as “PC Oppose.”

12 Public Counsel adjustments that either modify an adjustment originally  
13 proposed by Avista, or which are incremental to those proposed by Avista, are  
14 summarized on ensuing schedules contained within Exhibit No. JRD-2 or Exhibit  
15 No. JRD-3. In my narrative testimony supporting these adjustments, I refer to the  
16 schedule number within Exhibit No. JRD-2 or Exhibit No. JRD-3, as well as  
17 Public Counsel’s adjustment number designation.

18 **IV. HISTORY AND PRECEDENT FOR ADDRESSING REGULATORY LAG**  
19 **AND ADOPTING ATTRITION ADJUSTMENTS**

20 **A. Precedent Prior to 2012 Avista General Rate Case.**

21 **Q: Please summarize your understanding of this Commission’s view on the need**  
22 **for, and criteria for, adoption of attrition adjustments *prior to approval of the***  
23

1                    *non-unanimous stipulation in Avista's last general rate case – Dockets UE-*  
2                    *120436 et al.*

3            A:        Based upon research undertaken when reviewing Avista's 2012 general rate case,  
4                    I am aware that this Commission, though not in every docket where requested,  
5                    authorized adoption of attrition adjustments in general rate cases (GRC)  
6                    undertaken in the early 1980s that had similarities to the attrition adjustment  
7                    Avista is proposing in the current, as well as within its 2012 GRC, request.  
8                    Specifically, the first time that I am aware that the UTC allowed an attrition  
9                    adjustment was in a 1981 general rate case filed by Washington Water Power  
10                    Company (WWP), Avista's predecessor.<sup>1</sup> Adopting the recommendations of its  
11                    Staff, the UTC authorized an attrition adjustment in the 1981 WWP proceeding to  
12                    reflect rate year predicted revenues, expense and rate base levels.

13                    The UTC was specifically concerned about WWP's financial integrity and  
14                    ability to raise capital at reasonable rates when it broke from its prior precedent,  
15                    which consisted of routinely limiting utility rate development to use of historic  
16                    test years with traditional restating and proforma adjustments. It is also  
17                    noteworthy that when adopting its first-ever attrition adjustment, this Commission  
18                    emphasized attrition adjustments for WWP or any other utility under its  
19                    jurisdiction would be evaluated on a case-by-case basis.

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<sup>1</sup> *Washington Utilities & Transportation Commission v. The Washington Water Power Co.*, Cause Nos. U-81-16, Second Supplemental Order (November 25, 1981), 1981 Wash. UTC Lexis 3.



1       **Q: Did this Commission consider events, conditions and evidence on a case-by-**  
2       **case basis following the issuance of its order in Docket Nos. U-81-15 and U-**  
3       **81-16?**

4       A: Yes. For a period of years, the UTC at times accepted, and at times rejected, both  
5       its Staff's and other utility companies' proposals to incorporate an attrition  
6       adjustment in the development of various Washington regulated utility  
7       companies' requests for base rate relief.

8       **Q: When addressing the attrition issue in cases reviewed from the 1980s, did the**  
9       **UTC set forth specific criteria for adoption or rejection of attrition**  
10       **adjustment proposals?**

11       A: The Commission did not set out a specific "test" or formula in the orders  
12       addressing attrition requests in the 1980s. However, frequent references were  
13       made to the following conditions existing when attrition adjustments were  
14       accepted (or noted to be absent when attrition adjustments were rejected):

- 15               • High inflation
- 16               • High financing costs or interest rates– relative to embedded costs existing  
17               on the various companies' balance sheets at the time
- 18               • Large construction programs
- 19               • Vastly different rates of change in revenues, expenses, and rate base
- 20               • Deteriorating financial integrity – jeopardizing credit ratings and ability to  
21               economically finance needed construction

1           The last attrition adjustment that I am aware of that the UTC approved,  
2           prior to adoption of the significant implicit attrition adjustment embodied in the  
3           non-unanimous stipulation reached in Avista’s 2012 GRC, was in a 1986 Pacific  
4           Power and Light general rate case order.<sup>2</sup> Subsequent to that docket, the next  
5           time a Washington utility sought an attrition adjustment was in the Washington  
6           Natural Gas 1992 general rate case. The UTC rejected WNG’s attrition request,  
7           stating:

8                         The Commission concludes that no attrition adjustment  
9                         should be granted in this case. An adjustment for attrition  
10                        is an extraordinary measure, not generally included in  
11                        general rate relief. A request for attrition should be based  
12                        on extraordinary circumstances, not shown by the company  
13                        to be present in this case.<sup>3</sup>

14                        Subsequent to the Washington Natural Gas case just cited, I am not aware  
15                        of any utility requesting a specific attrition adjustment until Avista requested an  
16                        attrition adjustment in Dockets UE-120436 *et al.*

17  
18           **B.     More Recent Precedent for Addressing Regulatory Lag.**

19           **Q:     Thus far you have summarized this Commission’s precedent for addressing**  
20           **regulatory lag and adoption of attrition adjustments that was in place for at**  
21           **least two decades. Please summarize this Commission’s more recent actions**  
22           **and statements regarding the need to address regulatory lag.**

23  

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<sup>2</sup> *Washington Utilities & Transportation Commission v. Pacific Power & Light Co.*, Cause No. U-86-02, Second Supplemental Order, 1986 Wash. UTC Lexis 7, 47-50.

<sup>3</sup> *Washington Utilities & Transportation Commission v. Washington Natural Gas*, Docket UG-920840, Fourth Supplemental Order, 1993 WL500058, at 20. (September 27, 1993).

1       A:     While the subject of regulatory lag may have been mentioned or addressed in  
2             some manner in a number of GRCs occurring subsequent to the 1986 Pacific  
3             Power and Light general rate order mentioned previously, to the best of my  
4             knowledge the topic first again became highlighted in a 2011 GRC filed by Puget  
5             Sound Energy (PSE).

6                         Specifically, in Dockets UE-111048 and UG-111049, witnesses noted in  
7             testimony PSE’s inability to earn its authorized rate of return in recent years. In  
8             response to PSE claims of alleged attrition and rate requests, the UTC Staff  
9             proposed using an Expedited Rate Filing (ERF) as an additional mechanism –  
10            beyond GRCs – to assist PSE in addressing its alleged attrition problem. Staff’s  
11            ERF proposal in the 2011 PSE GRC envisioned that a utility would be permitted  
12            to make a rate filing that adhered to cost of capital, restating adjustments and class  
13            cost of service rate spreads and rate design adopted by the Commission in its most  
14            recent decision addressing such topics. So long as the utility undertook an ERF  
15            following principles adopted in the utility’s most recent GRC order, the docket  
16            could be expected to be processed with very little discovery and on a relatively  
17            quick procedural schedule. Inasmuch as there was no specific ERF proposal  
18            before it, this Commission made no specific determinations in connection with  
19            Staff’s proposal in the noted PSE docket, but effectively encouraged the parties to  
20            explore regulatory proposals “that might break the current pattern of almost  
21            continuous rate cases.”<sup>4</sup>

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<sup>4</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 & UG-111049, Order 08 ¶ 507 (May 7, 2012).

1       **Q: Please continue by summarizing the next regulatory action occurring in**  
2       **recent history that was designed to address earnings shortfall for regulated**  
3       **Washington energy utilities.**

4       A. On April 2, 2012 - while the 2011 PSE GRC docket was still open and before this  
5       Commission issued its decision in that docket - Avista filed a GRC for its electric  
6       and gas operations with a significant attrition adjustment. In that docket, the UTC  
7       Staff filed testimony that included a recommendation for adoption of a very  
8       significant attrition adjustment – similar in some respects to the Company’s  
9       proposed attrition adjustment. Notwithstanding the inclusion of a very significant  
10      attrition adjustment in its calculated revenue requirement for Avista’s electric and  
11      gas operations, Staff’s prefiled direct testimony nonetheless recommended a small  
12      electric operations rate *reduction* and a gas operations rate increase that was  
13      approximately forty percent (40.0%) of Avista’s filed request. Ultimately, Avista,  
14      Staff, Northwest Industrial Gas Users (NWIGU), and the Industrial Customers of  
15      Northwest Utilities (ICNU) entered into a stipulation in the noted 2012 GRC  
16      docket.

17                   Among other things, the multi-party stipulation provided for a first-step  
18      increase effective January 1, 2013, and a second-step increase effective January 1,  
19      2014, for Avista’s electric and gas operations. The increases were derived via a  
20      “black box” settlement wherein the parties did not delineate how such increases  
21      had been determined. That stated, it was abundantly obvious that the agreed upon

1 two-step increases for both electric and gas operations included a significant  
2 allowance for an attrition adjustment.<sup>5</sup>

3 The Commission adopted the non-unanimous stipulation over Public  
4 Counsel’s objection, with certain modifications to the agreement. One  
5 modification of some significance was this Commission’s designation of the  
6 second-step increase as “temporary” with an effective period of only one year.

7 **Q: In approving the non-unanimous stipulation, did this Commission endorse**  
8 **any specific attrition methodologies, approaches or assumptions?**

9 A. No. To the contrary, the Commission’s order specifically noted that it was *not*  
10 endorsing any specific attrition methodologies, assumptions or inputs.<sup>6</sup>

11 **Q: Did the Commission’s order conclude that the general conditions and criteria**  
12 **frequently cited in its orders adopting attrition adjustments in the early**  
13 **1980s were present in the Avista 2012 GRC?**

14 A: No. The Commission stated that it “intended to clarify the conditions wherein  
15 attrition should be considered when setting rates.” The Commission noted that  
16 the settlement limited its ability to provide that clarity, but that it would “in the  
17 near future initiate an inquiry into the appropriate use of attrition analysis in

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<sup>5</sup> Staff and Avista acknowledged in testimony supporting the stipulation that consideration had been given to an attrition adjustment. ICNU sponsored testimony supporting the stipulation but stated that from ICNU’s perspective the “black box” increase did not consider any attrition adjustment. Public Counsel presented testimony that concluded, given other items agreed to and expressed in the settlement, that the “black box” settlement must have been derived by considering a very significant attrition adjustment. Ultimately this Commission found that the non-unanimous stipulation “was based significantly on attrition.” *WUTC v. Avista Corporation.*, Dockets UE-120436 & UG-120437, Order 09 ¶ 70 (December 26, 2012).

<sup>6</sup> *Id.* ¶ 77.

1 setting rates, including the appropriate methodology to use in preparing attrition  
2 studies.<sup>7</sup>

3 **Q: Please continue by discussing the next regulatory action that has recently**  
4 **occurred that was designed to address earnings shortfall for regulated**  
5 **Washington energy utilities.**

6 A: In early February 2013, PSE filed petitions for electric and gas base rate relief,  
7 that became docketed as UE-130137 and UG-130138, utilizing an ERF approach  
8 along the lines that Staff had advocated in PSE's 2011 GRC that was described in  
9 an earlier answer. With limited testimony and exhibits, and with reflection of the  
10 cost of capital, and most - though not all - restating adjustments adopted by this  
11 Commission in its 2011 GRC order, PSE proposed to increase its Washington  
12 retail electric by approximately \$32.1 million and to reduce its gas operations'  
13 Washington retail rates by approximately \$1.2 million.

14 PSE's ERF dockets were combined with a decoupling request in Dockets  
15 UE-121697 and UG-121705, as well as a separate docket addressing a coal  
16 transition purchased power agreement after PSE, Staff and Northwest Energy  
17 Coalition (NWECC) reached a multi-party settlement. The multi-party settlement  
18 recommended a decoupling mechanism and an ERF increase, as well as a multi-  
19 year rate increase plan that relied upon abbreviated calculations fashioned to some  
20 extent after the early-1980s-styled attrition adjustments previously approved on  
21 occasion by this Commission. The Commission accepted the settlement, with  
22 minor modifications. Public Counsel and the Industrial Customers of Northwest

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<sup>7</sup> *Id.* ¶ 77.

1 Utilities (ICNU) challenged the Commission’s decision on the attrition  
2 adjustment. However, the Commission’s decision on the attrition adjustment  
3 granted to PSE survived the challenge.

4 **Q: Please continue by summarizing any additional utility applicant regulatory**  
5 **proposals and UTC regulatory decisions wherein the topics of regulatory lag**  
6 **and/or attrition were addressed.**

7 A: In January 2013, PacifiCorp filed a GRC that was designated as Docket UE-  
8 130043. PacifiCorp’s filing did not include a request for an attrition adjustment.  
9 PacifiCorp’s revenue requirement calculation started with an historic test year  
10 ending June 30, 2012, and was further developed by considering a number of  
11 typical “restating” and “proforma” adjustments. Of note, PacifiCorp’s proforma  
12 adjustments included several requests to include significant plant additions that  
13 were projected to be – and in some instances were – closed to Plant in Service  
14 during the discovery phase of the docket, as well as other plant additions that  
15 were not projected to be closed to Plant in Service until some months following  
16 the expected implementation date for revised retail electric rates resulting from  
17 the GRC docket. While the PacifiCorp-proposed proforma adjustments made to  
18 reflect post-test year plant additions were never described or designated as  
19 “attrition adjustments,” their proposals were undoubtedly made to address  
20 potential earnings deterioration expected as a result of regulatory lag.

21 Staff and Public Counsel accepted in part, and opposed in part, certain  
22 PacifiCorp-proposed proforma adjustments to reflect post-test year plant  
23 additions. In turn, this Commission accepted in part, and rejected in part, the

1 various parties' positions regarding inclusion of post-test year plant additions in  
2 the development of revenue requirement. When arriving at its decisions on  
3 various proforma adjustments to reflect post-test year plant additions, this  
4 Commission did not articulate or adhere to specific tests or criteria, instead  
5 choosing to rely on informed judgment for each decision being made.

6 PacifiCorp's prefiled testimony and exhibits did not address nor seek any  
7 form or mechanism to achieve expedited rate relief. However, in rejecting certain  
8 of PacifiCorp's very forward looking proforma plant adjustments, Staff  
9 recommended within concurrently filed testimony that PacifiCorp address  
10 perceived exposure to earnings shortfall that might occur as a result of this  
11 Commission rejecting a number of PacifiCorp's proposed proforma plant  
12 adjustments by making an Expedited Rate Filing along the lines that Staff had  
13 first suggested within PSE Docket UE-111048 *et al.* In general, Public Counsel  
14 very strongly encouraged the ERF approach to addressing regulatory lag, only  
15 offering certain additional conditions and requirements to be adhered to when a  
16 utility made such an ERF.

17 This Commission neither accepted nor rejected Staff and/or Public  
18 Counsel's various ERF proposals, stating these decisions were better addressed  
19



1 within a rulemaking docket.<sup>8</sup>

2 **Q: Have the issues of criteria, conditions, filing requirements, procedural**  
3 **schedules or any other elements surrounding rules to address Expedited Rate**  
4 **Filings been vetted within Docket A-130355?**

5 A: Docket A-130355 was established to consider a number of proposed rulemaking  
6 changes – including possible rules to address ERFs. As of the time this testimony  
7 was to be prepared, very few comments had been filed by parties that even  
8 mention ERFs – much less began vetting specific conditions, criteria, filing  
9 requirements or procedural schedules to be adhered to if, and when, a utility  
10 might choose to undertake an ERF.

11 **Q: Please summarize your observations of recent proposals and recent UTC**  
12 **decisions that focused upon potential mechanisms to address regulatory lag,**  
13 **earnings erosion or attrition.**

14 A: In less than a three year span, the Commission has been presented with widely  
15 divergent, non-traditional rate recovery proposals. During this time, this  
16 Commission has adopted an attrition adjustment and an ERF proposal. However,  
17 each “adoption” was by way of approval of non-unanimous stipulation. And in

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<sup>8</sup> Specifically on the topic of ERF proposals this Commission determined:

“We find Staff’s proposal of an ERF in this proceeding worthy of future consideration but premature in light of the Commission’s initiation of Docket A-130355. The ERF concept has its merits to be sure, but we not prepared in this case to embrace it in its nascent form as a substitute for other, more fully developed and familiar approaches to addressing regulatory lag. In this case, we are approving PacifiCorp’s use of EOP rate base, an approach the Commission has recognized for many years as an appropriate response to regulatory lag, particularly when associated with chronic under-recovery experience such as that of PacifiCorp during recent periods. We also are taking a more forward approach to allowing pro forma adjustments that capture the costs and benefits of upgraded production assets. This, too, is an approach with which the Commission has

1 each decision, no specific criteria, condition or methodology was generically  
2 approved or endorsed. To the contrary, this Commission has indicated that it  
3 would be addressing specific criteria, conditions and/or methodologies  
4 surrounding non-traditional rate proposals in future regulatory docket.  
5 Accordingly, as of this time this Commission has not stated its expectations or  
6 preferences for identifying *when* a non-traditional rate mechanism approach is  
7 warranted, and if deemed to be warranted or justified, what is the best non-  
8 traditional rate methodology to be undertaken.

9 **V. AVISTA'S ATTRITION ADJUSTMENT PROPOSAL**

10 **A. Summary of Avista's Proposed Attrition Adjustment.**

11 **Q: Please state your understanding of Avista's proposed attrition adjustment**  
12 **for its Washington jurisdictional electric operations.**

13 A: Ms. Elizabeth Andrews has developed an attrition adjustment for Avista's  
14 Washington jurisdictional electric operations that *increases* the claimed revenue  
15 deficiency by approximately \$33.7 million above and beyond what Avista  
16 calculates using a traditional test year approach that considers "restating"  
17 adjustments, its request for an increase in ROE to 10.1 percent, as well as more  
18 typical non-power supply "proforma" expense adjustments. The \$33.7 million  
19 attrition adjustment exceeds the total increase being requested by the Company.  
20 The Company's request for increased revenue for electric operations totals \$32.3  
21 million, which includes the January 1, 2014 temporary increase of approximately

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considerable experience and that has proven to be a useful means to reduce regulatory lag." *WUTC v. PacifiCorp*, Dockets UE-130043, Order 05 ¶ 217 (December 4, 2013).

1           \$14 million and the requested \$18.2 million above 2014 rates.<sup>9</sup> Inasmuch as the  
2           value of the Company’s attrition adjustment exceeds the totality of electric rate  
3           relief being requested in this proceeding, it is clear that Avista’s own revenue  
4           requirement calculations – inclusive of its request for an increase in ROE to 10.1  
5           percent but without consideration of the Company’s proposed attrition adjustment  
6           – would indicate a reduction from electric rates being collected in 2014 is  
7           warranted.

8           Ms. Andrews’ attrition adjustment was developed, in part, by calculating a  
9           five-year Compound Growth Rate in Washington jurisdictional electric Net Plant  
10          After Deferred Income Taxes,<sup>10</sup> as calculated and presented within Commission  
11          Basis Reports prepared for, and filed with, this Commission. The five-year  
12          Compound Growth Rate in Washington jurisdictional electric Net Plant After  
13          Deferred Income Taxes was then applied to the June 30, 2013 historic test year  
14          end-of-period “restated” Net Plant After Deferred Income Taxes valuation that  
15          Avista had calculated in the development of its “traditional” adjusted historic test  
16          year cost of service presentation. Because Ms. Andrews was attempting to  
17          develop projected Net Plant After Deferred Income Taxes for the 2015 “rate  
18          effective” period, occurring two years beyond the “restated” June 30, 2013-ending  
19          historic test year rate base valuation time frame, the five-year annual historic

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<sup>9</sup> On page 10 of Exhibit No. EMA-4, within the column entitled “Prior to 2014 Revenue Subtotal” Avista reflects needed rate relief of \$32,254,000. Within the column entitled “Revenue Normalization 2014” Avista reflects \$14,054,000 of rate relief that became effective on January 1, 2014. Thus, in the last column entitled “FINAL REV REQ TOTAL” Avista reflected the net increase of \$18,201,000 being sought in this proceeding above “temporary” 2014 rates currently being collected.

<sup>10</sup> Net Plant After Deferred Income Taxes was calculated by considering Plant in Service less Accumulated Depreciation and plant-related Accumulated Deferred Income Taxes.

1 average growth rate was “compounded” for two years to derive Ms. Andrews’  
2 proposed 2015 electric operations adjusted Net Plant After Deferred Income  
3 Taxes rate base valuation.

4 Ms. Andrews also developed five-year Compound Growth Rates for  
5 expenses grouped into three very large categories. More specifically, Ms.  
6 Andrews developed a five-year Compound Growth Rates for operation and  
7 maintenance expense--excluding production expenses which were separately  
8 addressed in the development of Avista’s proposed power supply costs.  
9 Additionally, Ms. Andrews developed a five-year Compound Growth Rate for  
10 depreciation expense as well as five-year Compound Growth Rate for Taxes  
11 Other Than Income Tax expense. While Ms. Andrews developed – utilizing five  
12 years of historic experience - an annual Compound Growth Rate for non-power  
13 supply operation and maintenance (O&M) expense of 7.86 percent, she  
14 nonetheless assumed an annual non-power supply operations and maintenance  
15 escalation rate of 4.0 percent. According to Ms. Andrews’ testimony, the 4.0  
16 percent escalation rate - rather than the annual Compound Growth Rate derived  
17 from five years of historic experience - was applied to “restated” non-power  
18 supply O&M expense “to reflect the recent cost-cutting measures implemented by  
19 the Company, and the expectation that Avista will manage the growth in these  
20 expenses to a lower level in future years.”<sup>11</sup>

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<sup>11</sup> Exhibit No.EMA-1T, p. 23.

1       **Q:   Please continue with your understanding of Ms. Andrews’ development of an**  
2       **electric operations attrition adjustment.**

3       A:   Ms. Andrews also developed a five-year Compound Growth Rate for  
4       miscellaneous Other Revenues that she applied to restated historic test year Other  
5       Revenue amounts.<sup>12</sup> However, for development of 2015 “rate year” revenues  
6       resulting from traditional retail energy sales, Ms. Andrews employed the  
7       Company’s current revenue model--or what I understand to be the billing  
8       determinants model underlying the Company’s 2015 revenue budget.

9               To summarize, historic test year “restated” expenses other than expense  
10       components considered in the development of Avista’s power supply cost  
11       adjustment, historic test year “restated” Other Revenues, as well as “restated”  
12       end-of-period Net Plant After Deferred Income Taxes were all escalated by  
13       considering five-year Compound Growth Rate percentages calculated from  
14       Washington jurisdictional Commission Basis Reports. Power supply costs were  
15       developed in the manner traditionally used in recent Avista base rate filings vis-à-  
16       vis employment of the Aurora model. Retail energy sales revenues were  
17       developed by considering billing determinants derived from the Company’s 2015  
18       revenue model. The revenue requirement that Avista calculated utilizing a  
19       traditionally-developed June 30, 2013-ending historic test year cost of service  
20       that considered “restated” and “proformed” operating results was then subtracted

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<sup>12</sup> For cost of service components valued at, or annualized to, the end of the historic test year (i.e., June 30, 2013) Avista applied a two-year compounded escalation factor to consider mid-2015 cost levels. For cost of service components that were not annualized to, or valued at, the end of the historic test year, Avista

1 from the revenue requirement derived by considering the attrition calculations  
2 described above to arrive at Avista’s proposed electric operations attrition  
3 adjustment of approximately \$33 million.

4 **Q: Was Ms. Andrews’ trend-driven calculations, in conjunction with 2015**  
5 **budgeted sales data, the only evidence offered by Avista in support of its**  
6 **electric operations attrition adjustment?**

7 A: No. Ms. Andrews also sponsors four adjustments to incorporate post test-year  
8 events and conditions expected to occur through the 2015 rate year. These  
9 additional proforma adjustments purportedly serve as a “cross check” to Ms.  
10 Andrews’ attrition study. The four “cross check” adjustments presented by Ms.  
11 Andrews include the following:

- 12 • The annual revenue requirement impact of planned capital additions from  
13 the end of the historic test year through the end of calendar year 2013  
14 *excluding distribution plant associated with connecting new customers*<sup>13</sup>  
15 as well as related changes to Accumulated Depreciation and Accumulated  
16 Deferred Income Taxes estimated through the end of 2013.<sup>14</sup>
- 17 • The annual revenue requirement impact of 2014 planned capital additions  
18 *excluding distribution plant associated with connecting new customers* as

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applied a two-and-one-half year compounded escalation factor to consider growth from the mid-point of the historic test year (December 31, 2012) through the mid-point of the 2015 rate year (June 30, 2015).

<sup>13</sup> Avista excluded in all of its “cross check” adjustments for post-test year plant additions distribution plant projects constructed to serve new customers.

<sup>14</sup> Avista Electric Operations Proforma Adjustment 4.00.

1 well as related estimated changes to Accumulated Depreciation and  
2 Accumulated Deferred Income Taxes.<sup>15</sup>

- 3 • The annual revenue requirement impact of 2015 planned capital additions  
4 *excluding distribution plant associated with connecting new customers* as  
5 well as related estimated changes to Accumulated Depreciation and  
6 Accumulated Deferred Income Taxes.<sup>16</sup> It is noted that for the 2015  
7 Planned Capital Additions “cross check” adjustment, rate base was valued  
8 using the projected average-of-monthly-average of Plant in Service,  
9 Accumulated Depreciation and Accumulated Deferred Income Tax  
10 balances.

- 11 • The annual revenue requirement impact of estimated “lost margins”  
12 calculated to be associated with energy savings attributable to the  
13 Company’s DSM program.<sup>17</sup>

14 The annual revenue requirement impact of the four “cross check” adjustments  
15 sponsored by Ms. Andrews, when added to Avista’s calculated historic test year  
16 Washington retail cost of service adjusted for traditional “restating” and  
17 “proforma” expense adjustments, summed to within \$61,000 of the mostly trend-  
18 driven attrition adjusted revenue requirement calculated by Ms. Andrews. Ms.  
19 Andrews therefore posts one additional “cross check” attrition adjustment in the  
20 amount of \$61,000 to simply force the revenue requirements generated from the  
21

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<sup>15</sup> Avista Electric Operations Proforma Adjustment 4.01.

<sup>16</sup> Avista Electric Operations Proforma Adjustment 4.02.

<sup>17</sup> Avista Electric Operations Proforma Adjustment 4.03.

1 sum of the four other “cross check” adjustments to equal the revenue requirement  
2 amount calculated by considering the trend-drive attrition adjustment.<sup>18</sup> Again,  
3 according to Ms. Andrews and the Company, the four “cross check” adjustments  
4 demonstrate the reasonableness and validity of the Company’s trend-drive  
5 attrition adjustment.

6 **Q: Did Avista employ a similar approach in developing an attrition adjustment**  
7 **for its Washington retail gas operations?**

8 A: Yes, Avista employed a virtually identical approach in developing an attrition  
9 adjustment for its Washington gas operations. As with electric operations, Avista  
10 relied upon five-year historic Compound Growth Rates experienced for Net Plant  
11 After Deferred Income Taxes, O&M expenses excluding purchased gas costs,  
12 Taxes Other Than Income, and Other Revenues to be applied to historic test year  
13 “restated” balances. Also as with electric operations, Avista employed a lower  
14 4.0 percent O&M escalation rate rather than utilizing the five-year Compound  
15 Growth Rate experienced for non-gas cost O&M expense of approximately 7.5  
16 percent. For gas operations, \$5.2 million of the total requested increase of \$12.1  
17 million is attributable to the Company’s attrition adjustment.<sup>19</sup>

18 **Q: Did Avista also present “cross check” adjustments to support its trend-**  
19 **driven attrition adjustment?**

20 A: Yes. However, since Avista’s gas operations have a revenue decoupling  
21 mechanism in place, no “cross check” adjustment to estimate “lost margins” from

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<sup>18</sup> Avista Electric Operations Proforma Adjustment 4.04.

<sup>19</sup> As indicated in Avista’s response to Public Counsel Data Request No. 023.



1 energy efficiency initiatives was presented. As with electric operations, the sum  
2 of traditional “restating” and “proforma” expense adjustments, plus the three post-  
3 test year “Proforma Cross Check Adjustments” did not exactly equal the trend-  
4 driven attrition revenue requirements. Accordingly, Ms. Andrews sponsors one  
5 additional gas operations “cross check” revenue requirement adjustment in the  
6 amount of \$429,000 to simply force the sum of the traditional restating, proforma  
7 and the three other “cross check” adjustments to equal Avista’s requested trend-  
8 drive attrition adjustment.<sup>20</sup>

9 **B. Results Observed Following Implementation of Avista’s Existing**  
10 **Attrition-Derived Rates.**

11 **Q: Avista’s Washington electric and gas operations rates resulting from the**  
12 **stipulation approved in Avista’s 2012 GRC became effective on January 1,**  
13 **2013. As you have noted, the Commission clearly recognized that the**  
14 **stipulated rates had some significant, albeit unstated and unquantified,**  
15 **allowance for an attrition adjustment. What financial results were achieved**  
16 **in 2013 – the first full year in which attrition-derived rates were in effect?**

17 **A:** Avista has filed Commission Basis Reports (CBR) for its Washington retail  
18 electric and gas operations for 2013. As shown on Table 1 below, overall Avista  
19 realized returns that are close to returns that were stated to be targeted in the prior  
20 case stipulation.  
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<sup>20</sup> The Company’s gas operations adjustment posted for force the sum of restated and proforma adjustment to equal its attrition-derived increase is adjustment 4.03.

1

<b>Table 1</b> <b>Avista Washington Retail Electric and Gas Operations</b> <b>Actual Versus Targeted Returns</b> Source: Response to PC-095-Revised			
Washington Retail Operations	Actual Earned Return on Equity	Targeted Return on Equity in Prior Case Stip	Actual Over/ (Under) Target
- Electric	9.9%	9.8%	0.1%
- Gas	7.2%	9.8%	(1.6%)
- Overall	9.5%	9.8%	(0.3%)

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**Q: Given regulatory returns earned, can one conclude that the first year of the two-year rate plan achieved the goals of addressing under earnings experienced in recent year?**

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**A:** Upon first impression, achievement of returns noted on Table 1 might suggest a “Goldilocks” outcome – with not too much, not too little, but just about the right amount of rate relief. Further, the Company now recommends a net \$18.2 million increase over 2014 electric rates – or an amount just slightly higher than the annual increases granted pursuant to the 2012 stipulation for years 2013 and 2014 - with continuing employment of an attrition adjustment fashioned largely after the Company’s attrition adjustment presented in its 2012 GRC application. The fact that the Company’s 2015 electric operations requested rate relief is somewhat in line with that granted for years 2013 and 2014 might also suggest that the trending approach underlying the Company’s attrition adjustment is working and quite precise. However, a closer a look at recent Company decisions to accelerate utility capital expenditures suggests it is appropriate for this Commission to reconsider this approach to developing retail rates.

1       **Q:    Please explain.**

2       A:    In its current application, as well as within its 2012 GRC application, Avista has  
3           consistently indicated that its earnings erosion – or inability to earn its targeted or  
4           authorized rate of return - was primarily impacted by its significant utility capital  
5           expenditures program. Company witness Mr. Scott Morris states within his direct  
6           testimony filed in this proceeding that “[t]he increase in overall costs to serve  
7           customers is driven primarily by two major factors: 1) the continuing need to  
8           replace and upgrade the facilities and technology we use every day to serve our  
9           customers and 2) low revenue growth.” In Avista’s 2012 proceeding, the  
10          Company provided testimony by Mr. Morris, Mr. Kelly Norwood and Dr. Mark  
11          Lowry all emphasizing to varying degrees that utilities nationwide generally need  
12          – and Avista specifically needs – to replace and upgrade utility infrastructure that  
13          was decades old. According to all the noted testimonies, the inability to realize  
14          targeted returns was most significantly impacted by the UTC’s employment of an  
15          historic test year, and more importantly, employment of an historic test year that  
16          was developed by valuing rate base by considering an average-of-monthly-  
17          averages of the various rate base components. According to Company  
18          testimonies, high capital expenditures, in combination with historic test year rate  
19          making that employed AMA rate base development, was creating significant  
20          regulatory lag that was thwarting Avista’s ability to earn its targeted rate of return.

21                        However, in the third quarter of 2013, several months following  
22                        implementation of new Washington retail rates that were developed by  
23                        considering a significant attrition adjustment, Avista began *increasing* its capital

1 expenditures program *above that it had presented in the 2012 GRC*. Specifically,  
 2 as reflected on Table 2 below, a comparison of Avista’s utility capital  
 3 expenditures plans for years 2013 through 2016 as forecasted at the time of its  
 4 2012 GRC versus what is being forecasted in the timeframe of the current GRC  
 5 reveals just how dramatically Avista has increased construction expenditures  
 6 following implementation of Washington retail rates that embodied a large  
 7 attrition adjustment.

8 **[Begin Confidential]**

<b>Table 2</b>			
<b>Capital Expenditures Forecast – 2012 GRC Forecast Versus Current 2014 GRC Forecast (\$ millions)</b>			
<b>Year</b>	<b>2012 GRC Forecast<sup>21</sup></b>	<b>Current 2014 GRC Forecast<sup>22</sup> (2013 amount shown is actual Cap X)</b>	<b>% Increase – Current 2014 GRC Versus 2012 GRC</b>
2013			
2014			
2015			
2016			
Sum Years 2013 thru 2015			
Sum Years 2013 thru 2016			

9 **[End Confidential]**

10 Thus, while Avista’s Washington electric operations marginally exceeded the  
 11 targeted ROE of 9.8 percent and combined Washington electric and gas

<sup>21</sup> Amounts reflected in this column represent Avista’s utility capital expenditures forecast provided in response to data requests from Dockets UE-120436 & UG-120437 (PC\_DR\_121C Confidential Attachment C.xlsx). Public Counsel refers to PC\_DR\_121C from the 2012 general rate case with Avista’s consent.

<sup>22</sup> Amounts reflected in this column were provided in response to PC Data Request PC\_DR\_065C Confidential Attachment A. Amount for 2013 reflects Avista’s actual 2013 utility capital expenditures. Amounts shown for years 2014 – 2016 reflect Avista’s current forecast for utility capital expenditures.

1 operations marginally fell short of the targeted ROE of 9.8 percent, such return  
2 results were realized in 2013 when Avista increased utility capital expenditures by  
3 **[Begin Confidential ██████████ End Confidential]** over what had been  
4 forecasted in 2012. By way of “cross check” adjustments similar to what Avista  
5 presented in this proceeding, Avista’s capital budget for calendar year 2013  
6 indirectly supported its attrition adjustment proposed in the 2012 GRC for “rate  
7 year 2013.”

8 **Q: Would Avista’s request for additional rate relief in 2015 in this proceeding be**  
9 **impacted by the significant increase in capital expenditures now forecasted**  
10 **for years 2014 and 2015 versus what Avista was forecasting for years 2014**  
11 **and 2015 in its 2012 GRC?**

12 **A:** No, or certainly not directly. It should be remembered that Avista’s attrition  
13 adjustment for Net Plant After Deferred Income Taxes, Depreciation Expense,  
14 Taxes Other Than Income, and Other Revenues is developed by applying the five-  
15 year Compound Growth Rate experienced for each noted cost of service  
16 component for the period 2007 through 2012. Thus, in theory Avista could have  
17 increased its 2013 – 2015 capital expenditures forecast by 40 percent or lowered  
18 its 2013 – 2015 capital expenditures forecast by 40 percent from that which it was  
19 predicting in 2012 – and its attrition adjustment being presented in the current  
20 case would remain exactly the same amount. However, if Avista had not  
21 significantly increased its 2013 – 2015 forecast of capital additions from that  
22 predicted in the 2012 GRC, the sum of the Company’s “Pro Forma Cross Check”  
23 adjustments would not have “checked out” or demonstrated the reasonableness of

1 its trend-drive attrition adjustment being recommended in this proceeding. More  
2 specifically, as described in earlier testimony, the Company's "Pro Forma Cross  
3 Check" adjustments sum to an amount that is almost identical to its attrition  
4 adjustment that support its rate request in the current proceeding. Thus,  
5 undoubtedly if Avista were to substitute the much lower 2013 – 2015 capital  
6 expenditures forecast provided within the 2012 GRC when developing its "Pro  
7 Forma Cross Check" adjustments in the instant case, the sum of its "Pro Forma  
8 Cross Check" adjustments would have revealed that its current attrition  
9 adjustment is significantly overstated.

10 The other items to appropriately consider when reviewing Avista's request  
11 for an electric operations annual increase of \$18.2 million in this proceeding is  
12 that such increase was calculated by considering 1) a higher return on equity than  
13 was stipulated to in the 2012 GRC, and 2) a new methodology for valuing rate  
14 base that has the impact of increasing Avista's rate base request in this case  
15 compared to what was presented in the 2012 GRC.

16 **Q: Please expand upon why it is appropriate to consider the two noted items**  
17 **when evaluating Avista's attrition request in this proceeding.**

18 A: In the 2012 GRC, this Commission approved the stipulation that specifically  
19 embodied a 9.8 percent ROE. In this case Avista is recommending a ROE of 10.1  
20 percent. The impact of the Company's requested increase in ROE, calculated by  
21 considering the Company's electric and gas operations rate base request, is to  
22 increase the Company's electric and gas operations requested increase by  
23 approximately \$3.3 million and \$.6 million, respectively.

1           The Company is also requesting, for the first time in this proceeding, to  
2 include in rate base valuation pensions/post-retirement benefits liabilities and  
3 associated regulatory assets, as well as all Accumulated Deferred Income Tax  
4 balances related to such pensions/post-retirement benefits liabilities and  
5 regulatory assets.<sup>23</sup> The impact of such new methodology for valuing rate base is  
6 to increase Avista’s electric and gas operations requested rate relief by  
7 approximately \$1.6 and \$1.0 million, respectively. Thus, but for Avista’s request  
8 for a higher ROE and a new methodology for valuing rate base, Avista’s  
9 requested increase – all other items held constant – would be reduced to  
10 approximately \$13.3 million and \$11.1 million for electric and gas operations,  
11 respectively. In other words, if such Company proposals are stripped out of the  
12 Company’s overall request in this proceeding, the “remaining” electric and gas  
13 operations increases calculated to be occurring as a result of “cost changes” since  
14 the 2012 GRC are less significant.

15       **Q: In an earlier answer you suggested that whether Avista had increased or**  
16 **decreased its capital additions forecast from that provided in the 2012 GRC,**  
17 **its attrition adjustment would remain the same in the instant case even**  
18 **though its “Pro Forma Cross Check” adjustments would no longer support**  
19 **the same attrition adjustment. Is the fact that the Company’s “Pro Forma**  
20 **Cross Check” adjustments closely approximate its attrition adjustment**  
21 **request to be expected?**

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<sup>23</sup> Exhibit No. EMA-1T, pp. 38 and 67.

1           A:     Yes, given the way the Company chose the period to calculate a Compound  
2                   Growth Rate to be applied to test year “restated” operating results. Specifically,  
3                   as indicated from the quotation below taken from Ms. Andrews’ testimony filed  
4                   in this proceeding, the Company essentially chose the historic study period that  
5                   supports its now accelerated capital expansion program underlying its “Pro Forma  
6                   Cross Check” adjustments:

7                               The Company chose to use the five-year Compound Growth Rate  
8                               of 2007-2012. Inspecting the results, it can be seen that the growth  
9                               in cost categories, such as depreciation expense and net plant, has  
10                              tended to be higher since 2007. Based on the Company’s plan for  
11                              higher capital expenditures in future years, it is appropriate to use  
12                              the compound annual growth rates for the 2007-2012 period for  
13                              rate base and depreciation expenses.<sup>24</sup>

14                              In effect, the Company reflects “Pro Forma Cross Check” adjustments to  
15                              test the supposed reasonableness of its massive attrition adjustments that are most  
16                              significantly impacted by trend-driven rate base growth. Yet, the trend period  
17                              employed to develop the Company’s attrition adjustment were specifically chosen  
18                              to consider “the Company’s plan for higher capital expenditures in future years.”  
19                              In effect, the Company’s “Pro Forma Cross Check” adjustments provide no  
20                              independent assessment of the reasonableness of its attrition adjustment. Rather,  
21                              the Company’s cross check adjustments merely demonstrate that Avista very  
22                              accurately picked an historic trend period that supports the construction program  
23                              Avista would like to embark upon.  
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<sup>24</sup> Exhibit No. EMA-1T, p. 23.



1       **Q: Do you know of any other considerations that impact the reasonableness of**  
2       **employing the trend period of 2007 through 2012 to calculate a Compound**  
3       **Growth Rate to apply to Net Plant After Deferred Taxes?**

4       A: Yes. The 2007 through 2012 timeframe includes a period of time when Avista  
5       increased its capital budget to catch up for projects that were postponed for  
6       calendar years 2000 through 2005. Specifically, in response to a Staff data  
7       request, Avista stated the following addressing a question surrounding why  
8       general plant in service additions were relatively flat between 2005 and 2006:

9               Between 2000 and 2005, Avista was responding to adverse  
10              conditions that included a drought and an increase in costs to  
11              provide electricity from alternate sources to hydro-generation. This  
12              included buying power from external sources. During this time  
13              Avista chose a lower capital budget, which would maintain the  
14              reliability of our power grid, but postponed some capital  
15              investments. From 2006 to 2012, Avista increased its capital  
16              budget to address projects that were postponed.<sup>25</sup>

17  
18              Thus, not only has Avista chosen an historic trend period to match the  
19              capital expenditures program it wants to embark upon, the historic trend period it  
20              has chosen included to some significant degree “accelerated” capital expenditures  
21              to catch up for capital projects that had been postponed for a period of years  
22              preceding the historic trend period chosen to calculate the Compound Growth  
23              Rate escalator to be applied to test year “restated” values.

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<sup>25</sup> Quotation taken from Avista’s response to Staff Data Request No. 092 that has been affixed to this testimony in its entirety as Exhibit No. JRD-4C.

1       **Q:    What is the revenue requirement impact of the *increase* in Avista’s**  
2       **forecasted capital expenditures program for the 2013 through 2015 time**  
3       **frame that has been implemented since Avista’s 2012 GRC?**

4       A:    Inasmuch as the forecast for capital expenditures for years 2014 and 2015 was  
5       never provided on a utility-operations or state-jurisdictional basis in the 2012  
6       GRC, one cannot know the answer to that question with certainty.<sup>26</sup> However,  
7       clearly the impact of increasing its capital expenditures program is causing the  
8       purported need for rate relief in this proceeding to be significantly increased.  
9       Specifically, as derived from forecasted total company capital expenditures shown  
10      on Table 2 above, Avista increased planned expenditures for the 2013 through  
11      2015 time frame by **[Begin Confidential]** ██████████ **[End Confidential]** million since  
12      the 2012 GRC.<sup>27</sup> Applying a conservatively low estimate of 12.0 percent to  
13      consider return, related federal income taxes, and depreciation to such 2013 -  
14      2015 *increase* in capital expenditures, one can estimate that in excess of **[Begin**  
15      **Confidential]** ██████████ **[End Confidential]** million in total company revenue  
16      requirements is associated with Avista’s decision to increase its capital  
17      expenditures program since the 2012 GRC.<sup>28</sup> Again, since Avista never provided

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<sup>26</sup> This conclusion was also confirmed through Avista’s response to Public Counsel Data Request No. 201 wherein Avista was requested to recalculate its “cross check” forecasted plant addition adjustments based upon its forecast prior to the recent decision to accelerate its capital expenditures program.

<sup>27</sup> Projected utility capital expenditures for the 2013 – 2015 time frame provided in the 2012 GRC was **[Begin Confidential]** ██████████ **[End Confidential]** million. Avista’s forecasted 2014 and 2015, as well as 2013 actual capital expenditures total to **[Begin Confidential]** ██████████ **[End Confidential]** million, resulting in a **[Begin Confidential]** ██████████ **[End Confidential]** million increase in forecasted utility capital expenditures for the 2013 – 2015 timeframe from that projected at the time of Avista’s 2012 GRC.

<sup>28</sup> Public Counsel is recommending a before-tax cost of capital in this proceeding of 9.7 percent. Adding an assumed composite annual plant depreciation rate of 2.3 percent one can arrive at a “conservatively low estimate of 12.0 percent to consider return, related federal income taxes, and depreciation” associated in capital expenditures. Applying the 12.0 percent factor to the assumed **[Begin Confidential]** ██████████ **[End**

1 a breakdown of its forecasted capital expenditures program between utility  
2 operations and jurisdictions in the 2012 GRC, it cannot be determined how much  
3 of the [Begin Confidential] [REDACTED] [End Confidential] million “total company”  
4 increase in revenue requirements resulting from its now accelerated construction  
5 program can be attributable to Avista’s Washington electric or gas operations.  
6 But, given that Avista’s Washington electric and gas operations represent  
7 approximately two-thirds of Avista’s total electric and total gas operations,  
8 undoubtedly the majority of the [Begin Confidential] [REDACTED] [End Confidential]  
9 million “total company” revenue requirement increase attributable to Avista’s  
10 plan to accelerate or expand its capital expenditures program will ultimately be  
11 assigned to Avista’s Washington electric and gas operations.

12 **Q: Has Avista explained or defended its decision to significantly accelerate its**  
13 **construction program?**

14 A. According to the testimony of Mr. Mark Thies, the three primary drivers of the  
15 need to increase Avista’s level of capital investment include:

- 16 • The business need to fund a greater portion of the departmental  
17 requests for new capital investments that in the past have not been  
18 funded
- 19 • The need to capture investment opportunities and benefits  
20 identified by Avista’s asset management capabilities, and

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**Confidential]** million total increase in capital expenditures, one arrives at the estimated annual revenue requirements associated with such increase in capital expenditures of [Begin Confidential] [REDACTED] [End Confidential] million – or “in excess of \$25 million.”

- 1 • A continued focus on controlling the increase in operations and  
2 maintenance spending through prudent capital investment.

3 Additionally, according to Mr. Thies' testimony, Avista has chosen to accelerate  
4 its capital spending at this particular time to take advantage of near all-time lows  
5 in interest rates – and thus avoiding future increases in interest rates and inflation.  
6 Finally, Mr. Thies acknowledges that Avista does not currently have a need for  
7 new capacity and energy resources that would otherwise put upward pressure on  
8 retail rates.<sup>29</sup>

9 **Q: When Avista's Board of Directors considered the accelerated capital**  
10 **expenditures program that the Company has now embarked upon, was it**  
11 **presented with the same considerations that Mr. Thies' testimony describes**  
12 **as being instrumental in the decision to increase capital spending?**

13 A: In response to Public Counsel Data Request No. 22, Avista provided excerpts of  
14 the pertinent pages from draft presentations among officers and presentations  
15 made to the Board of Directors. The response to Public Counsel Data Request  
16 No. 22, as well as Confidential Attachment A to Public Counsel Data Request No.  
17 22, have been affixed to this testimony as Exhibit No. JRD-5C. **[Begin**

18 **Confidential]** [REDACTED]  
19 [REDACTED]  
20 [REDACTED]  
21 [REDACTED]  
22 [REDACTED]

1 [REDACTED]

2 [REDACTED]

3 [REDACTED]

4 [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 [REDACTED]

8 [REDACTED]

9 [REDACTED]

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED]

21 [REDACTED]

22 [REDACTED]

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<sup>29</sup> Exhibit No.MIT-1T, pp. 6 and 7.

1 [REDACTED]

2 [REDACTED]

3 [End Confidential]

4 **Q: Does the presentation to the Board of Directors contradict any claims or**  
5 **statements made in Mr. Thies' or any other Avista witnesses' testimony**  
6 **regarding the reasons the Company elected to embark upon the accelerated**  
7 **construction program at this particular point in time?**

8 A: Nothing in the presentation directly contradicts any testimonial claims made  
9 regarding implementing the accelerated capital expenditures program at this time.

10 [Begin Confidential] [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED] [End Confidential]

18 **Q: Are you suggesting that Avista's decision to accelerate its capital**  
19 **expenditures program are imprudent?**

20 A: No. To make such a determination would likely require an extensive and  
21 expensive management audit outside the confines of a rate case procedural  
22 schedule.

1           **VI. AVISTA'S ATTRITION ADJUSTMENT SHOULD BE REJECTED AND**  
2           **OTHER MECHANISMS TO ADDRESS REGULATORY LAG SHOULD**  
3           **BE ADOPTED**

4  
5           **Q: Given your observations, what are your specific recommendations regarding**  
6           **the development of Avista's Washington retail base rates in this proceeding**  
7           **and at least for the short term future?**

8           **A:** My specific recommendations for the development of Avista's rates in this  
9           proceeding, and for the ensuing approximate two year period, include:

- 10                   • Avista's attrition adjustment proposed for both its electric and gas  
11                   operations should be rejected.
- 12                   • However, to address concerns of regulatory lag, potential earnings erosion,  
13                   and the strain of nearly continuous annual general rate cases, I further  
14                   recommend:
  - 15                           ○ Rates established in this proceeding should be developed by  
16                           valuing rate base utilizing end-of-test-period balances for Net Plant  
17                           After Deferred Income Taxes.
  - 18                           ○ An adjustment to reflect a post-test year update for growth in Net  
19                           Plant After Deferred Income Taxes through March 31, 2014 should  
20                           also be adopted to reduce regulatory lag from the cost  
21                           measurement period to the rate effective period.
  - 22                           ○ Avista should be permitted to file two Expedited Rate Filings  
23                           before being required to make a GRC filing to further increase  
24                           base rates. As I shall explain in more detail in ensuing testimony,

1                   there should be relatively few restrictions in the timing of ERFs or  
2                   test years to be employed so as to allow Avista maximum  
3                   flexibility in making such filings, which in turn, should permit the  
4                   Company to minimize regulatory lag and potential earnings  
5                   erosion.

6           **Q:    Are you effectively recommending that this Commission reconsider its**  
7           **willingness to approve attrition adjustments?**

8           A:    Yes. I am respectfully requesting that this Commission reconsider its use of  
9           attrition adjustments, and instead, utilize a number of tools available to it in its  
10          regulatory tool box that have not been fully utilized.

11          **Q:    Please expand upon why you believe it is appropriate for this Commission to**  
12          **reconsider its recent actions of adopting an attrition adjustment, and instead,**  
13          **adopt your alternative proposals to address regulatory lag.**

14          A:    First, I realize this rate application essentially provides the first report card on the  
15          UTC’s recent adoption of an attrition adjustment. It is admittedly a relatively  
16          short period of time that includes results for only one Washington energy utility.  
17          However, Avista’s recent earnings experience, and its decision to accelerate its  
18          construction program at this time strongly suggest that, but for accelerating its  
19          construction program and selectively choosing a trend-period to support its now  
20          accelerated construction program, and asking for a higher ROE, Avista could not  
21          support maintaining existing 2014 electric operations rates currently in effect –  
22          much less support any type of increase in electric rates in 2015 above such  
23          existing “temporary” 2014 rates in effect. Such results suggest that it is



1 reasonable for this Commission to reconsider adoption of attrition adjustments in  
2 the establishment of base rates at this time.

3 Second, I submit that ultimately arriving at a one-size-fits-all attrition  
4 adjustment approach will be very challenging. Further, notwithstanding this  
5 Commission’s statement that it intends to address the “appropriate methodology  
6 to use in preparing attrition studies,”<sup>30</sup> it is possible that it may ultimately elect to  
7 adopt differing approaches to developing attrition adjustments on a case-by-case  
8 basis. However, I submit that reserving the ability to decide the methodology to  
9 develop an appropriate attrition adjustment for each individual situation will be  
10 equally challenging and confusing.

11 Third, utilization of ERFs along with other mechanisms and procedures  
12 have not been fully developed and attempted as a means of addressing the  
13 concerns of regulatory lag, potential earnings erosions, and the fatigue being  
14 experienced as a result of often annual – or nearly annual - GRCs.

15 To summarize, I respectfully submit that this Commission moved too  
16 quickly and too far to address the noted concerns when it adopted the attrition-  
17 based stipulation in the 2012 GRC before exploring and adopting ERFs and other  
18 regulatory tools. These alternatives still largely adhere to “historic actual”  
19 ratemaking principles, but nonetheless represent a progressive solution that  
20 provides serious and significant movements to address the noted concerns of  
21 regulatory lag, earnings erosions, and GRC fatigue.

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<sup>30</sup> *WUTC v. Avista Corporation d/b/a/ Avista Utilities*, Dockets UE-120436 and UG-120437  
(*Consolidated*), Order 09 ¶ 77, December 26, 2012.

1       **Q: Please discuss some of the concerns and challenges that you believe will be**  
2       **faced if the attrition adjustment approach continues to be considered or**  
3       **employed.**

4       A: First, the question arises as to what conditions should be present before an  
5       attrition is to be considered. As discussed earlier, to date, no inquiry rulemaking  
6       docket, or other process has been undertaken to vet the circumstances deemed  
7       necessary to exist before an attrition adjustment would be considered. Thus, at  
8       this time Avista is proposing another significant attrition adjustment before this  
9       Commission has established the criteria for considering an attrition adjustment.

10      **Q: Beyond concerns addressing the circumstances expected to exist before an**  
11      **attrition adjustment is considered, are there significant challenges to**  
12      **developing the methodology to employ when developing an attrition**  
13      **adjustment?**

14      A: Yes. One need not look any further than Avista’s proposal in the instant case to  
15      be concerned with the array of options that may arise in developing an  
16      “appropriate attrition methodology.” First, as noted, Avista chose a recent five-  
17      year historic period to develop a Compound Growth Rate to be applied to  
18      “restated” test year balances of Net Plant After Deferred Income Taxes to derive  
19      the “rate year” rate base valuation. As was previously explained, the five-year  
20      historic period that was chosen to match or prove the reasonableness of its current  
21      accelerated construction also included an accelerated or “catch up” construction  
22      program. Growth in non-power supply O&M expense was first evaluated by  
23      Avista by considering actual experience for a recent five-year historic period.

1           However, instead of applying the approximate eight percent (8.0%) annual growth  
2           rate experienced for the recent five-year historic period to non-power supply cost  
3           O&M expenses, the Company employed its judgment to adopt a lower four  
4           percent (4.0%) annual growth rate that reflected the Company’s recent cost  
5           cutting measures implemented to manage growth in expenses. Finally, for sales  
6           or revenue growth, Avista ignored historic growth over any period, choosing  
7           instead to reflect billing determinants from its 2015 revenue forecast.

8                       Thus, in this particular case, Avista has selected a specific historic trend  
9           period to purportedly demonstrate the reasonableness of its accelerated  
10          construction program, chosen a non-power supply escalation rate to match its cost  
11          cutting expectations, and reflected its own 2015 forecast for revenues – to arrive  
12          at the “appropriate methodology” to derive an attrition adjustment. The  
13          Company’s mix-and-match approach to developing its proposed attrition  
14          adjustment should reveal the significant challenges this Commission will face  
15          when it attempts to provide guidance as to an appropriate methodology in  
16          deriving an attrition adjustment.

17          **Q: Please continue by describing in more detail the various processes and**  
18          **procedures you are recommending in this proceeding to address regulatory**  
19          **lag.**

20          **A:** First, I am recommending that Avista’s electric and gas operations rate base  
21          valuation for Net Plant After Deferred Income Taxes be established by  
22          considering end-of-historic-test year balances. Or more specifically, I am  
23          supporting Avista’s electric operations Adjustment No. 2.17 and Avista’s gas

1 operations Adjustment No. 2.15 – both of which have been proposed to restate  
2 Net Plant After Deferred Income Taxes from an AMA rate base valuation to an  
3 end of historic test year basis. These adjustments also incorporate the  
4 annualization of depreciation expense based upon end of test year Plant in Service  
5 value. Public Counsel has endorsed these types of end-of-period (EOP) rate  
6 base/depreciation expense adjustment in the last Avista and PacifiCorp GRCs, as  
7 well as within the Puget Sound Energy ERF made in early 2013. While adoption  
8 of such Company-proposed EOP adjustments might appear to be relatively minor  
9 concessions today, it should be remembered that prior to 2012, EOP rate base  
10 valuation had typically been rejected by this Commission in favor of AMA  
11 valuation. Inasmuch as EOP rate base valuation shortens the period between cost  
12 measurement and the rate effective period by approximately six months from that  
13 derived with AMA rate base valuation, it represents a significant action to address  
14 concerns of regulatory lag.<sup>31</sup>

15 Second, I am recommending adoption of an “update” adjustment  
16 undertaken to value Net Plant After Deferred Income Taxes through March 31,  
17 2014. Additionally, as with the Company’s EOP “restating” Adjustment Nos.  
18 2.17 and 2.15 for electric and gas operations, respectively, I am also proposing to  
19 adjust depreciation expense by “annualizing” depreciation based upon March 31,  
20 2014 Plant in Service balances. By including Net Plant After Deferred Income  
21 Taxes for rate base valuation, and annualizing depreciation based upon March 31,

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<sup>31</sup> Under the AMA methodology, rate base is valued at approximately the middle of the historic test year. Thus, by moving from AMA to EOP rate base valuation, regulatory lag associated with the Company’s

1 2014 balances, regulatory lag will have been reduced by nine months from that  
2 developed employing EOP historic test year ratemaking principles, and by fifteen  
3 months from that developed employing AMA historic ratemaking principles.

4 Third, I am recommending that Avista be permitted to file, with limited  
5 constraints, two ERFs before being required to make a new GRC filing. Without  
6 limitations as to what test year to employ, or when it should make such filings, the  
7 Company retains maximum flexibility so as to minimize regulatory lag following  
8 incurrence of any significant cost increase that cannot otherwise reasonably be  
9 expected to be offset by revenue growth.

10 **Q: Why do you view your various proposals to be superior to adoption of an**  
11 **attrition adjustment?**

12 A: Each of my individual proposals, and cumulatively all the proposals together,  
13 significantly reduce regulatory lag. Further, by relying upon actual incurred and  
14 verifiable costs, the subjectivity, ambiguities and confusion that appears likely to  
15 be experienced when an attrition adjustment is employed will be avoided. By  
16 utilizing procedures and methodologies that rely upon “actual” investment and  
17 expense levels, as well as actual recent sales volumes, many controversies  
18 surrounding adoption of attrition adjustments are avoided while regulatory lag is  
19 reasonably minimized.

20 Some additional Staff and intervenor resources can be expected to be  
21 deployed to review a utility’s ERF. However, so long as the filing is made strictly

22  

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capital expenditures program is reduced by approximately six months.

1 compliant with past ratemaking principles adopted, and so long as filing  
2 requirements are established that minimize the requirements for discovery, such  
3 resource and time requirements should be very modest relative to processing a full  
4 GRC application.

5 **Q: In previous answers you have frequently characterized your various**  
6 **proposals as “reducing” or “minimizing” regulatory lag. Could your various**  
7 **proposals completely eliminate regulatory lag?**

8 A: It may not be possible in all situations to completely eliminate regulatory lag.  
9 However, given the great deal of flexibility being recommended for undertaking  
10 ERFs and the next GRC, I would expect any earnings erosion due to regulatory  
11 lag to be modest.

12 **Q: Why would you expect earnings erosion resulting from regulatory lag under**  
13 **your various proposals to be modest?**

14 A: Impacts from plant closings or significant expense increases are frequently  
15 “lumpy,” and the times of their exact incurrence are frequently knowable in  
16 advance, or in some instances partially controllable by utility management. For  
17 instance, closing a major plant addition, or perhaps a number of plant additions, is  
18 known fairly precisely months in advance of completing construction. Thus, the  
19 timing of an ERF can be made to minimize the period time between “cost  
20 incurrence” and the rate effective period. Similarly, granting annual cost of living  
21 and other wage increases typically occur at a particular point in the year. Thus,  
22 once again, the timing of an ERF can be planned to minimize regulatory lag for

1 scenarios where growth in revenues does not appear to be fully offsetting growth  
2 in cost to serve.

3 Another fact to remember is that, notwithstanding frequent GRCs in recent  
4 years in Washington, growth in cost to serve (return on investment plus expense  
5 recovery) does not always exceed growth in revenues for all years or for all  
6 months of a given calendar year. For instance, last year I participated in a GRC in  
7 Nevada wherein a regulated electric utility filed for a rate reduction and in which  
8 the Public Utilities Commission of Nevada ordered an even larger rate reduction  
9 than the utility had recommended.<sup>32</sup> Further, even for utilities that have been  
10 experiencing a need for annual, or nearly annual, base rate relief, such utilities  
11 sometime experience months within a given twelve month period where Net Plant  
12 After Deferred Income Taxes declines for a period of time before again resuming  
13 a year-over-year increase. Such partial year reduction in rate base valuation  
14 sometimes occurs as seasonal construction additions slow while growth in the  
15 Accumulated Depreciation Reserve and Accumulated Deferred Income Taxes  
16 continue – thus resulting in a rate base decline for a portion of a given twelve  
17 month period. With maximum flexibility to file ERFs, Avista as well as other  
18 Washington utilities could time such filings to capture the EOP rate base  
19 valuation at peak before any mid-annual-period decline that might occur, and

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<sup>32</sup> In Docket No. 13-06002 Sierra Pacific Power Company filed for an electric operations rate reduction of \$9.4 million, and by order issued on December 16, 2013 the PUCN reduced rates by \$37.1 million. The application was required to be made pursuant to statute. In the absence of the statutory requirement to make a filing, it is highly unlikely that Sierra Pacific Power Company would have filed for a rate change at a time that it was experiencing electric operations over earnings.

1 effectively minimize, if not eliminate earnings erosion resulting from  
2 disproportionate rate base growth.

3 Finally, I am aware that this Commission, as well as commissions around  
4 the country, sometimes considers utility applications to obtain an accounting  
5 authority order (AAO) to defer for future recovery costs that would otherwise be  
6 immediately charged to operations. While I am not encouraging use of AAOs to  
7 address regulatory lag, it should be recognized that such mechanism is an option  
8 for a utility to request, and for this Commission to consider authorizing, when the  
9 utility is facing a unique and significant cost event that might create earnings  
10 erosions even with the flexible ERF plans being recommended herein.

11 **Q: In prior periods, has this Commission as well as the Staff ascribed to the**  
12 **theory that a degree of regulatory lag provides incentives for regulated**  
13 **utilities to invest and operate efficiently?**

14 A: Yes. In PSE GRC Dockets UE-111048 and UG-111049, Mr. Ken Elgin  
15 appearing on behalf of Staff first advocated in direct testimony employment of an  
16 ERF as an appropriate mechanism to address regulatory lag and earnings erosions.  
17 In such testimony Mr. Elgin also included the following conclusions regarding  
18 regulatory lag:

19 **Q: Are the effects of attrition and regulatory lag always “bad”?**

20 A: No. Regulatory lag should inspire utility managers to control costs  
21 aggressively to achieve the lowest reasonable cost of service,  
22 which is a good thing for both the utility and its rate payers.  
23 Attrition caused by increasing construction budgets also should  
24 inspire utility management to carefully evaluate capital budgets  
25 and approve only those projects absolutely necessary. I mentioned  
26 this earlier in my testimony when discussing the Commission’s



1 decision to reject future test periods based on budgets. This  
2 incentive also is consistent with the *Bluefield* and *Hope* standards  
3 regarding efficiency and our statutes governing the obligation of a  
4 public service company to keep its facilities safe, adequate and  
5 efficient.<sup>33</sup> Finally, the Commission has recognized that historical  
6 test periods and regulatory lag are self-regulating mechanisms that  
7 provide the proper incentive for utilities to control costs.<sup>34</sup>  
8

9 Further, in a 2009 GRC order, this Commission observed that some degree  
10 of regulatory lag “motivates PSE and other utilities subject to our jurisdiction to  
11 carefully manage their costs and revenues moving forward.”<sup>35</sup>

12 In summary, the cumulative impact of the various rate proposals I am  
13 recommending should significantly minimize regulatory lag, though it may not  
14 totally eliminate regulatory lag in each situation or scenario. But, for reasons  
15 recently discussed by Staff as well as this Commission itself – with which I fully  
16 agree – exposure to a degree of regulatory lag can “provide the proper incentive  
17 for utilities to control costs.”

18 **VII. PROPOSED CONDITIONS TO BE IMPOSED WHEN AN EXPEDITED**  
19 **RATE FILING IS UNDERTAKEN**

20  
21 **Q: You recommend that Avista be authorized to undertake Expedited Rate**  
22 **Filings to address regulatory lag. Please summarize the major conditions**  
23 **you are recommending as necessary for an appropriate ERF filing.**  
24

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<sup>33</sup> RCW 80.28.010(2).

<sup>34</sup> Dockets UE-111048 and UG-111049; Exhibit No. KLE-1T, p. 70.

<sup>35</sup> *WUTC v. Puget Sound Energy*, Dockets UE-090704 and UG-090705, Order 11, at ¶ 23 (April 2 2010).

1           A:     I am recommending that the following conditions and/or filing requirements be  
2                     adopted for any ERF mechanism to be approved for Avista:

3                     • Avista should be required to calculate and post *all restating*  
4                             adjustments adopted by the WUTC in its last general rate case order  
5                             prior to the ERF proceeding. The calculation and posting of all  
6                             restating adjustments should be a filing requirement of any ERF  
7                             application, and the filing should be made with all supporting  
8                             spreadsheet files provided at the time of the filing. Further, the ERF  
9                             should be developed by including the ROE authorized by the  
10                            Commission in this GRC. Finally, rates should also be developed by  
11                            adhering to class cost of service and rate design principle adopted by  
12                            the Commission in this GRC.

13                    • Avista should be required to provide evidence that a reasonable effort  
14                            has been undertaken to identify, quantify, and eliminate from the  
15                            ERF test year cost of service material abnormal, non-operating and  
16                            non-recurring transactions.

17                    • Revenue relief to be granted through the ERF process should be  
18                            limited to no more than three percent above existing base rates.

19                    • Avista should be permitted to file an ERF utilizing a non-calendar test  
20                            year with no restriction as to the earliest date that such filing could be  
21                            made.

- 1                   • Avista should be permitted to undertake two ERF filings before being  
2                   required to make a GRC filing to further increase base rates. During  
3                   any ERF proceeding the Company would be prohibited from filing a  
4                   general rate case.

5                   I would note that the conditions set forth above are consistent with Public  
6                   Counsel’s recommendations regarding ERFs in the most recent PacifiCorp  
7                   GRC – Docket UE-130043.

8                   **Q: Please continue by explaining the need for your first condition when**  
9                   **undertaking an ERF application – namely, that Avista should be required to**  
10                   **calculate and post *all* restating adjustments adopted by the WUTC in its last**  
11                   **general rate case order.**

12                   A: The need for, and propriety of, such requirement should be obvious. In the  
13                   context of an expedited rate proceeding, a goal should be to arrive at a relatively  
14                   simple and non-controversial cost of service presentation that adheres to past  
15                   Commission precedent regarding allowable costs for rate recovery. As such, it is  
16                   equitable, and indeed necessary, to consider restating adjustments.

17                   Basically, the “exchange” that occurs with an ERF application is that the  
18                   utility receives very accelerated review and implementation of requested rate  
19                   relief while Staff and interested intervenor parties can expect a “clean” filing that  
20                   reflects no new theories, arguments or approaches in developing rates, but rather,  
21                   reflects *all and only previously UTC approved* restating adjustments. The utility  
22                   may not necessarily agree with restating adjustments adopted in the previous

1 GRC, but nonetheless would be expected to post *all* such adjustments in exchange  
2 for accelerated rate relief with presumed limited need for discovery. Conversely,  
3 of course, Staff and intervening parties may also not agree with all previously  
4 approved restating adjustments. But again for purposes of processing an ERF,  
5 would forego the right to suggest new arguments in opposition to restating  
6 adjustments most recently approved in a GRC order, and would forego the right to  
7 suggest or recommend new restating adjustments. To be clear, all parties would  
8 always be permitted to oppose previously approved restating adjustments or  
9 propose new restating adjustments in the context of Avista's next GRC.  
10 However, such positions just could not be advocated in the context of an ERF  
11 application.

12 **Q: Could a negotiated general rate case settlement create concern or confusion**  
13 **in a subsequent ERF proceeding?**

14 A: Yes. In a black box settlement, or a settlement that was reached without  
15 delineating how the various parties or the Commission arrived at the agreed upon  
16 increase, there will not be a trail as to what restating adjustments were considered  
17 in the settlement. Similarly, there may or may not be a stated cost of capital, and  
18 there may not be a trail as to which jurisdictional or class cost of service  
19 allocation factors or procedures were envisioned with the settlement.  
20 Accordingly, it is imperative that, at a minimum, any negotiated settlement set  
21 forth elements as to what cost of capital, what jurisdictional allocations, and what  
22 restating adjustments were assumed in arriving at the settlement increase.

23 Without such findings set forth, it is difficult to envision how any number of

1 controversies could be handled expeditiously or avoided within an ERF  
2 proceeding.

3 **Q: Please continue by discussing the need for your second condition that with**  
4 **any ERF application Avista should be required to provide evidence that a**  
5 **reasonable effort has been undertaken to identify, quantify, and eliminate**  
6 **from the ERF test year cost of service material, abnormal and non-recurring**  
7 **transactions.**

8 A: This recommendation represents a filing requirement intended to streamline and  
9 assist in expediting the review process. It is intended to provide at least modest  
10 assurances that the ERF test year has been appropriately adjusted to reflect normal  
11 and ongoing conditions.

12 **Q: Are Commission Basis Reports required to eliminate material abnormal and**  
13 **non-recurring events or items?**

14 A: Yes. As required by WAC 480-100-257 (1) (b), a Commission Basis Report  
15 (CBR), which is intended to become the underlying ratemaking vehicle in the  
16 ERF process, must include:

17 Results of operations adjusted for any material out-of-period,  
18 nonoperating, nonrecurring, and extraordinary items or any other  
19 item that materially distorts reporting period earnings and rate  
20 base.

21  
22 Thus, any utility making a CBR filing is already expected to eliminate material  
23 extraordinary and nonrecurring events and transaction. Therefore, my second  
24 recommended ERF condition is simply a filing requirement that would have  
25 Avista provide evidence demonstrating that it had undertaken a review, search or

1 audit to identify and quantify for removal of any material out-of-period, non-  
2 operating, nonrecurring and extraordinary items when preparing its CBR. Since  
3 the identification and quantification tasks are already a CBR requirement, the  
4 filing requirement embodied in my second condition should represent a fairly  
5 modest effort on the utility's part to simply provide documentation of the  
6 processes and exercises undertaken in such identification and quantification effort  
7 that would significantly assist in the Staff and intervenors' ERF review efforts.

8 **Q: Please expand upon your third condition that rate relief to be granted**  
9 **through the ERF process should be limited to no more than three percent**  
10 **above existing rates**

11 A: The Commission's rule at WAC 480-07-510 defines a general rate proceeding as  
12 a proceeding in which the amount requested would increase a utility's gross  
13 annual revenue by three percent or more. Pursuant to the noted rule, when a  
14 utility requests an increase in rates of three percent or more through a general rate  
15 case it must meet detailed filing requirement. My proposed condition that ERFs  
16 be limited to situations wherein a utility is requesting no more than three percent  
17 is consistent with WAC 480-07-510, and effectively simply equates to a  
18 recommendation that the noted rule remain enforce.

19 **Q: Please state the reasons – beyond merely compliance with WAC 480-07-510 -**  
20 **why an ERF should be limited to three percent.**

21 A: Very simply, the ERF process is a unique process designed specifically to  
22 accommodate a shorter and less thorough review. It is intended to address  
23 regulatory lag, fairly continuous under earnings, as well as rising rate case costs

1 and rate case fatigue that are a fall out of annual or nearly-annual full blown  
2 general rate case reviews. While there may be benefits of the ERF process to  
3 consumers as well as utility applicants, implementation of an ERF does  
4 nonetheless represent a concession from the consumers' perspective because the  
5 typical scrutiny afforded a general rate application is relaxed and diminished. In  
6 light of such a concession, I believe it is reasonable that the ERF process be  
7 limited to addressing less significant needs for rate relief, or more specifically,  
8 that the ERF process should limit the applicant's increases to no more than three  
9 percent of existing base rates.

10 An expedited rate proceeding, by its very nature, is intended to be a  
11 limited update of costs with an accelerated review period. If the ERF were to  
12 raise rates by three percent or more, by rule, it would constitute a general rate case  
13 which would require substantial additional evidence and a comprehensive review  
14 by the Commission of earnings, revenues and expenses, including a determination  
15 of rate of return, before increasing rates. These requirements are essential to the  
16 Commission's duty to regulate utilities in the public interest.

17 **Q: Please expand upon your recommendation that Avista should be permitted to**  
18 **make an ERF utilizing a non-calendar test year, with no restriction as to the**  
19 **earliest date that such filing could be made.**

20 **A:** Such conditions will provide Avista considerable latitude in the timing of any  
21 ERF so as to minimize regulatory lag, and correspondingly, most efficiently  
22 address the potential for earnings erosions. While from the ratepayers'  
23 perspective this could be viewed as a considerable "concession," I nonetheless

1 believe it is reasonable so long as other conditions I am recommending be applied  
2 to the ERF are concurrently adopted. To address the Commission's stated policy  
3 goal of breaking the recent pattern of almost continuous rate cases and to explore  
4 innovative ways to address a utility's potential earnings erosion, Public Counsel is  
5 amenable to the relatively new conventions of 1) end-of-test-year rate base  
6 valuation, and 2) Expedited Rate Filings, combined with 3) allowing utilities  
7 maximum flexibility in the selection of ERF test years to employ and the timing  
8 of ERFs. These concessions have been supported with the condition that rates  
9 continue to be established – whether in GRCs or ERFs – utilizing historic test  
10 years and actual-incurred and verifiable cost elements properly matched or  
11 synchronized with attendant revenue levels to a similar or identical point in time.  
12 As evidenced by my recommendations, while continuing to recommend  
13 adherence to only considering historic costs in the rate setting process, I am  
14 correspondingly recommending processes and procedures that are designed to  
15 significantly shorten the time span between cost measurement in the ratemaking  
16 process and the effective date of new rates being developed in the various rate  
17 setting processes.

18 **Q: Please expand upon your final condition that Avista be permitted to file two**  
19 **ERFs, but that to further increase base rates beyond two ERFs, it should be**  
20 **required to undertake a GRC filing.**

21 A: While my recommended ERF process would result in limitations as to what the  
22 utility applicant could include in its rate request, as well as the maximum amount  
23 of the request, the process nonetheless will be abbreviated, or expedited, thus



1 limiting Staff and Intervenors' ability to review the utility's practices, procedures  
2 and investment decisions more intensively, such as occurs within GRC  
3 application reviews. Thus, some limitation as to the number of ERFs to be filed  
4 before a more detailed GRC review is undertaken is reasonable and critical. I  
5 believe the condition of limiting ERFs to two before requiring a utility to  
6 undertake a GRC, when viewed in conjunction with the conditions that a utility  
7 should be permitted to file non-calendar ERF test years without a minimum time  
8 restriction between ERFs, is balanced and reasonable.

9 **VIII. ADJUSTMENTS RELATED TO PUBLIC COUNSEL'S POSITION**  
10 **REGARDING ATTRITION AND REGULATORY LAG**

11  
12 **Q: Are you sponsoring specific adjustments that are intended to be responsive to**  
13 **Avista's request for attrition adjustments in this proceeding?**

14 **A:** Yes. However, I would first note that I am specifically opposing the Company's  
15 electric and gas operations attrition adjustments. Therefore, on behalf of Public  
16 Counsel, I am opposing the following electric operations proforma  
17 adjustments proposed by Avista:

<u>Adjustment Number</u>	<u>Adjustment Description</u>
4.01	Planned Capital Additions 2014 EOP
4.02	Planned Capital Additions 2015 AMA
4.03	DSM (proforma lost margins)
4.04	Reconcile Pro Forma to Attrition

23 Company electric adjustments 4.01 and 4.02 calculate the revenue requirements  
24 associated with budgeted 2014 and 2015 plant additions *other than* distribution  
25 plant additions directly associated with customer growth. Adjustment 4.03  
26 estimates annual lost margins attributable to Demand Side Management

1 initiatives. Adjustment 4.04 is merely a “plug” adjustment to force the sum of the  
2 Company’s “Pro Forma Cross Check” adjustment numbers 4.00, 4.01, 4.02 and  
3 4.03 as well as the Company’s various other restating and pro forma expense  
4 adjustments to equal the total electric attrition adjustment sponsored by Ms.  
5 Andrews.

6 For gas operations, on behalf of Public Counsel I am opposing  
7 the following adjustments proposed by Avista:

<u>Adjustment Number</u>	<u>Adjustment Description</u>
4.01	Planned Capital Additions 2014 EOP
4.02	Planned Capital Additions 2015 AMA
4.03	Reconcile Pro Forma to Attrition

12 As with Avista’s electric operations, Company gas adjustment numbers 4.01 and  
13 4.02 calculate the revenue requirements associated with budgeted 2014 and 2015  
14 plant additions *other than* distribution plant additions directly associated with  
15 customer growth. Adjustment 4.03 is merely a “plug” adjustment to force the  
16 sum of the “cross check” adjustment numbers 4.00, 4.01, 4.02 and 4.02 as well as  
17 the Company’s various other restating and pro forma expense adjustments to  
18 equal the total gas attrition adjustment sponsored by Ms. Andrews.

19 **Q: Please identify the adjustments included within Exhibit No. JRD-2 and**  
20 **Exhibit No. JRD-3 that relate to Public Counsel’s position regarding attrition**  
21 **and regulatory lag.**

1 A: The following Public Counsel adjustments are proposed to reflect consideration  
 2 and measurement of cost of service component changes that were experienced  
 3 post-test year and closer to the rate effective date.

<b>Table 3</b> <b>Identification of Public Counsel Post-Test Year Adjustments</b> <b>Offered to Address Concerns of Regulatory Lag</b>		
Adjustment No.	Adjustment Description	Exhibit/Schedule Reference
PC-E.2.10 A	Revenue Normalization	Exhibit No. JRD-2, Sch. No. 3
PC-E.3.02	Proforma Non-Labor Expense	Exhibit No. JRD-2, Sch. No. 4
PC-E.3.04	Proforma Employee Benefits Expense	Exhibit No. JRD-2, Sch. No. 5
PC-E.3.05	Proforma Insurance Expense	Exhibit No. JRD-2, Sch. No. 6
PC-E.3.06	Property Tax	Exhibit No. JRD-2, Sch. No. 7
PC-E.4.00 A	Actual Capital Additions March 31, 2014	Exhibit No. JRD-2, Sch. No. 8
PC-G.2.10	Revenue Normalization	Exhibit No. JRD-3, Sch. No. 3
PC-G.3.00	Proforma Non-Labor Expense	Exhibit No. JRD-3, Sch. No. 4
PC-G.3.02	Proforma Employee Benefits Expense	Exhibit No. JRD-3, Sch. No. 5
PC-G.3.03	Proforma Insurance Expense	Exhibit No. JRD-3, Sch. No. 6
PC-G.3.04	Proforma Property Tax	Exhibit No. JRD-3, Sch. No. 7
PC-G.4.00A	Actual Capital Additions March 31, 2014	Exhibit No. JRD-3, Sch. No. 8

4  
 5 **Q: Please continue by discussing the adjustments you are proposing for revenue**  
 6 **normalization for electric and gas operations.**

1       A:     Electric operations Adjustment No. PC-E.2.10 A and gas operations Adjustment  
2             No. PC-G.210 A are proposed to reflect annualized net margins resulting from  
3             customer growth from the historic test year ending June 30, 2013 through March  
4             31, 2014 – which is the date through which I am proposing to update actual  
5             electric and gas operations Plant in Service less Accumulated Depreciation and  
6             Accumulated Deferred Income Taxes.

7                     By way of background, I am specifically *supporting* the Company’s  
8             electric operations Restating Adjustment No. 2.17 and gas operations Restating  
9             Adjustment No. 2.15 in consideration of “regulatory lag” and earnings attrition  
10            concerns. The Company’s electric operations Restating Adjustment No. 2.17  
11            reflects rate base values at June 30, 2013 rather than the historic test year average-  
12            of-monthly average balance shown in the starting point Results of Operations  
13            presentation. Restating Adjustment No. 2.17 reflects “annualized” depreciation  
14            expense associated with such historic test-year end Plant in Service values.  
15            Similarly, the Company’s gas operations Restating Adjustment No. 2.15 reflects  
16            rate base values at June 30, 2013 rather than the test year average-of-monthly  
17            average balance shown in the starting point Results of Operations presentation,  
18            and also reflects “annualized” depreciation expense associated with such test year  
19            end Plant in Service values.

20                    Additionally, I am specifically supporting the Company’s electric  
21            operations “Pro Forma Cross Check” Adjustment No. 4.00 Planned Capital  
22            Additions Through December 2013 EOP and the Company’s gas operations “Pro  
23            Forma Cross Check” Adjustment No. 4.00 Planned Capital Additions Through

1 December 2013 EOP.<sup>36</sup> Further, I am also proposing one additional rate base  
2 adjustment for electric and gas operations to reflect actual Net Plant After  
3 Deferred Federal Income Taxes balances at March 31, 2014, as well as a corollary  
4 income statement adjustment to reflect “annualized” depreciation expense  
5 calculated based on March 31, 2014 actual Washington jurisdiction electric and  
6 gas operations Plant in Service.

7 **Q: Why do you characterize your acceptance of the noted Company-proposed**  
8 **electric and gas operations restating adjustment numbers 2.17 and 2.15,**  
9 **respectively, as responsive to concerns of earnings attrition and regulatory**  
10 **lag?**

11 A: As previously described in my testimony, valuing rate base employing the  
12 Average of Monthly Averages of test year balances of Net Plant After Deferred  
13 Income Taxes effectively establishes the rate base valuation in approximately the  
14 middle of the historic test year – or in this case, approximately December 31,  
15 2012. Thus, by establishing the rate base valuation for Net Plant After Deferred  
16 Income Taxes at June 30, 2013 – or the end of the historic test year, regulatory lag  
17 for this cost of service component is reduced by approximately six months.

18 **Q: Please continue your explanation of the electric and gas operations revenue**  
19 **normalization adjustments you are proposing.**

---

<sup>36</sup> As noted elsewhere in testimony, I am proposing an adjustment to update Net Plant After Deferred Income Taxes for actual balances at March 31, 2013. Thus, while I am accepting herein an “estimate” of end-of-2013 balances, any variance between originally-estimated and actual December 31, 2013 balances is effectively eliminated with the update adjustment I propose to reflect March 31, 2014 balances.

1       A:     First, regardless of the test year mechanism employed, an axiom adhered to by  
2             regulators is that test year revenues should be measured or calibrated with test  
3             year rate base valuation. In cases using AMA rate base valuation, it is  
4             unnecessary, and indeed it would be inequitable, to annualize revenues or margins  
5             for growth in customers that typically occurred *within and throughout* a given  
6             historic test year. However, when test-year-end rate base valuation is employed,  
7             it is reasonable and consistent to annualize revenues or margins from customers  
8             taking service at test year end. Annualization of revenues associated with year-  
9             end numbers of customers being served properly matches revenues with test-year-  
10            end rate base investment.

11            The Company developed its Restating Adjustment 2.10 to normalize test  
12            year revenues for electric and gas operations, as well as to adjust revenues for the  
13            impact of the January 1, 2013 rate increase that was only in effect for one-half of  
14            the historic test year. I do not take exception to the Company's electric and gas  
15            operations adjustment calculated to normalize revenues for historic test year  
16            weather aberrations as well as to annualize the impact of the January 1, 2013 rate  
17            increase granted. However, if test-year-end valuation of rate base is to be  
18            adopted, it is also essential to annualize revenues associated with test-year-end  
19            numbers of customers. Additionally, inasmuch as I am updating rate base  
20            valuation for Net Plant After Deferred Income Taxes through March 31, 2014, it  
21            is also consistent and equitable to annualize margins associated with customer  
22            growth through March 31, 2014 so that test year revenues are property matched  
23            with the March 31, 2014 updated Net Plant After Deferred Income Taxes

1 valuation. Accordingly, while I have accepted and support the Company's  
2 electric and gas operations restating Adjustment No. 2.10 as presented, I also  
3 propose a "PC Incremental" adjustment to electric and gas operations to reflect  
4 margins associated with customer growth through March 31, 2014. Specifically,  
5 Public Counsel's incremental adjustments designated as PC-E.2.10 A and PC-  
6 G.210 A are proposed to reflect annualized electric and gas operations margin  
7 growth associated with customers added from the historic test year through March  
8 31, 2014. Also reflected as a partial offset to margin growth are corollary  
9 adjustments to reflect associated increases in uncollectible accounts expense,  
10 WUTC Fees expense, and Washington Excise Taxes. Each noted corollary  
11 expense adjustment was calculated in a manner consistent with that proposed by  
12 the Company when developing its "Revenue Growth" adjustment, posted as an  
13 element of its attrition adjustment, and as reflected on page 4, column (J), of  
14 Exhibit No. EMA-2 and Exhibit No. EMA-3 for electric and gas operations,  
15 respectively.

16 **Q: Please state how the adjustment to capture growth in customer margins**  
17 **through March 31, 2014 was calculated.**

18 A: As reflected on Schedule No. 3 of Exhibit No. JRD-2 and Exhibit No. JRD-3, I  
19 calculated an adjustment to recognize growth in margins from the end of the  
20 historic test year through March 31, 2014, by prorating the portion of growth in  
21 margins that Avista predicts to occur from the June 2013-ending test year through  
22 the 2015 rate year to reflect growth that can be expected to have occurred by  
23 March 31, 2014.

1       **Q:   Why did you undertake a revenue growth adjustment that relies, in part,**  
2       **upon the Company’s 2015 margin forecast?**

3       A.   First, in theory the annualization of revenues for customers taking service at the  
4       end of a particular month would appear to be straight forward, and consist of the  
5       following steps:

- 6                       •   No. of Customer Taking Service at Period End by Rate Class
- 7                       •   Normalized Annual Billing Determinants per Customer by Times  
8                               Rate Class
- 9                       •   Times Currently Effective Tariff Rates
- 10                      •   Annualized Revenues by Rate Class Associated With Period  
11                               Equals End Number of Customers
- 12
- 13
- 14

15       However, two events are occurring with Avista’s customer base that cause what  
16       should be expected to be a straightforward calculation to be somewhat  
17       challenging. First, Avista appears to have some degree of seasonal customers.  
18       By “seasonal customers,” I am referring to customers who only take service for a  
19       portion of the year – or perhaps only one or a few of all the seasons, but  
20       completely disconnect their home or business from the utility’s distribution  
21       system for the remainder of the year. When “seasonality” is experienced, the  
22       customer counts, while generally increasing year over year, for certain months of  
23       the year actually decline before once again resuming upward growth. Thus, if one  
24       were to annualize revenues based upon a high or low month of seasonally-  
25       connected customers, the revenue annualization result would likely be somewhat  
26       over or under stated, respectively.



1                   Second, some degree of migration between rate classes is occurring. As a  
2 result, it is difficult to estimate or calculate annualized billing determinants for  
3 customers who have migrated sometime during the historic period being  
4 analyzed. The two events noted to be occurring with Avista's customer base  
5 combine to make estimating revenues associated with March 31, 2013 number of  
6 customers challenging. Accordingly, I undertook a calculation as reflected on  
7 Schedule No. 3 of Exhibit No. JRD-2 and Exhibit No. JRD-3 that I believe is  
8 reasonable, if not conservative, in deriving an adjustment required to estimate  
9 margin growth associated with growth in numbers of customers and usage from  
10 the end of the test year through March 31, 2014.

11       **Q: Why do you believe the revenue adjustments you have calculated**  
12       **conservatively estimate margin growth from test year end through March 31,**  
13       **2014?**

14       A: On Table 4 below, I reflect the percentage growth in customers and normalized  
15 sales/throughput occurring between the test year ending June 30, 2013, and the  
16 twelve months ending March 31, 2014, for electric and gas operations. Table 4  
17 also reflects the revenue growth that I employed in developing my revenue  
18 annualization adjustment found on Schedule 3 of Exhibits JRD-2 and JRD-3,  
19 which was based upon a proration of revenue growth predicted by the Company  
20 to occur between the test year and the 2015 rate year.

21

1

<b>Table 4            Comparison of Percentage Growth in Normalized            Sales and Numbers of Customers from            Test Year End Through March 31, 2014            Versus the Percentage Growth Assumed in the Public            Counsel’s Revenue Annualization Adjustment</b>		
	Electric Operations	Gas Operations
Percentage Growth in Total Number of Customers – Test Year Average Versus Average for 12 Months Ending March 31, 2014	0.72%	0.59%
Percentage Growth in Total Number of Customers – Test Year End Versus Customers Taking Service at March 31, 2014	1.35%	1.34%
Percentage Growth in Total Number of kWh sales (electric operations) or Mcf Throughput (gas operations)	1.55%	4.85%
Growth Factor Employed With Revenue Annualization Adjustment Found on Schedule No. 3 of Exhibits JRD-2 and JRD-3	0.62%	0.65%

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As can be observed from growth percentages shown on Table 4, the factors I have applied to test year base revenues to derive annualized revenues associated with growth from the test year through March 31, 2014, is significantly below actual growth in normalized sales/throughput volumes experienced between the test year and the twelve months ending March 31, 2014. The growth factor utilized in my adjustments is also in line with the growth in average number of customers experienced from the test year through the twelve months ending March 31, 2014, and significantly below the growth in number of customers actually taking service at June 30, 2013 through March 31, 2014. That stated, I believe the more

1 significant percentage growth in numbers of customers taking service at test year  
2 end versus March 31, 2014, has been influenced by the “seasonality” of customers  
3 taking service for only portions of any given twelve month period – as described  
4 above.

5 In any event, given that the growth factors I employed in my revenue  
6 annualization adjustments are considerably lower than the percentage growth in  
7 normalized sales/throughput volumes experienced between June 30, 2013 and  
8 March 31, 2014, and very much in line with growth in average numbers of  
9 customers served for the twelve months ending June 30, 2013 and March 31,  
10 2014, I conclude that the growth factors I have employed are not only reasonable,  
11 but in all likelihood, conservatively calculated.

12 **Q: Have you calculated attended increases in expenses that would accompany**  
13 **increases in throughputs and revenues calculated on Schedule No. 3 of**  
14 **Exhibit No. JRD-2 and Exhibit No. JRD-3?**

15 A: Yes. I have calculated attendant increases in power supply costs for electric  
16 operations, and attendant increases in purchased gas costs for gas operations.  
17 Additionally, I have adjusted uncollectible accounts expense, WUTC fees, and  
18 revenue taxes for the growth in revenues calculated. Each accompanying expense  
19 increase was consistently calculated utilizing ratios or percentages that the  
20 Company employed when it calculated growth in revenues from the test year  
21 through the 2015 rate year.

22 **Q: Please continue by discussing the next electric and gas operations**  
23 **adjustments you are sponsoring intended to address regulatory lag.**

1 A: Avista proposes a number of “Pro Forma” expense adjustments that were  
2 undertaken to estimate 2015 levels of expense. Specifically, Avista proposes the  
3 following electric and gas pro forma expense adjustments to capture 2015 levels  
4 for certain relatively large categories of expense:

<b>Table 5</b>		
<b>Pro Forma Adjustments Proposed by Avista To Reflect Expected 2015 Expense Levels</b>		
<b>Adjustment Description</b>	<b>Electric Adj’t No.</b>	<b>Gas Adj’t No.</b>
Labor Non-Executive Expense	3.02	3.00
Employee Benefits Expense	3.04	3.02
Insurance Expense	3.05	3.03
Property Tax Expense	3.06	3.04

5  
6 Based upon my experience with Washington energy utility GRC applications  
7 *preceding* the 2012 Avista GRC application, I believe the noted pro forma  
8 expense adjustments are similar to pro forma expense adjustments traditionally  
9 proposed by utility applicants. However, I would note two differences between  
10 the pro forma expense adjustments *traditionally* proposed by utility applicants  
11 prior to the 2012 Avista GRC and Avista’s proposal in the instant case. First,  
12 Avista has reached and estimated expense price changes all the way through the  
13 entire 2015 rate year. This, I believe, is further outside the test year than energy  
14 utilities typically proposed or that this Commission typically accepted with regard  
15 to pro forma non-power supply expense adjustments.

16 Second, while Avista proposes the noted pro forma expense adjustments,  
17 like the other “Pro Forma Cross Check” adjustments that Avista offers for  
18 budgeted post-test year plant in service growth, the revenue requirement impact of

1 the noted pro forma expense adjustments are effectively replaced – or superseded  
2 – by the Company’s attrition adjustment. In other word, regardless of whether  
3 one might conclude that such Company-proposed pro forma expense adjustments  
4 are significantly over or understated, from the Company’s perspective its rate  
5 request remains fully intact and justified. More specifically, per the Company’s  
6 request in this case, even if a party or this Commission were to conclude that a  
7 Company-proposed pro forma expense adjustment were significantly overstated,  
8 the Company’s request would remain identical. The only value that would  
9 change, again according to the Company’s position, is the “plug” Adjustment  
10 Nos. 4.04 and 4.03 for electric and gas operations, respectively, so that the sum of  
11 the various Company-proposed traditional restating and pro forma adjustments  
12 would always exactly equal the Company’s attrition-adjusted revenue increase  
13 request.

14 **Q: Please state which elements of the Company’s pro forma expense**  
15 **adjustments you are accepting and which elements you are proposing to**  
16 **modify or reject.**

17 A: I am proposing to modify the Company’s electric operations Pro Forma  
18 Adjustment 3.02 and the Company’s gas operations Pro Forma Adjustment 3.00.  
19 Each of the noted Company adjustments reflect wage increases for non-executive  
20 employees expected to occur through 2015 – or the first year rates resulting from  
21 these dockets are expected to be in effect. The impact of the modifications to the  
22 noted Company proposed electric and gas operations wage changes are reflected  
23 within adjustments I have designated as PC-E 3.02 and PC-G 3.00.

1                   When calculating its proposed pro forma level of non-executive labor  
2                   expense, Avista annualized the impact of wage increases granted in the first  
3                   quarter of 2014 and also calculated the impact of 2015 *expected* wage increases  
4                   for those months of 2015 that such increases are predicted to be in effect. I have  
5                   accepted that portion of Avista’s payroll adjustment that captures the annualized  
6                   impact of the increases that became effective in March 2014. However, I have  
7                   eliminated, or excluded, the predicted 2015 wage increases when calculating  
8                   proforma non-executive labor expense in adjustments PC-E 3.02 and PC-G 3.00.

9                   **Q: Why have you eliminated the 2015 wage increases included within the**  
10                   **Company’s development of pro forma non-executive labor expense?**

11                   A: The union and non-union 2015 increases are planned increases that do not meet  
12                   the “known and measurable” standard promulgated by WUTC rules. Further,  
13                   such estimated increases are predicted to occur well beyond the historic test year  
14                   ending June 30, 2013. Inclusion of such estimated increases occurring so far  
15                   beyond the end of the historic test year creates a test year mismatch of revenues,  
16                   expenses, and rate base – and should therefore be excluded. Conversely, the wage  
17                   increases effective in March 2014, which I have accepted and included in the  
18                   development of revised non-executive labor adjustments I am proposing, are  
19                   properly synchronized with the rate base valuation cutoff date that I am reflecting,  
20                   as well as the incremental Public Counsel adjustments undertaken to reflect  
21                   margin growth associated with customer growth through the same point in time  
22                   (PC-E.2.10 A and PC-G 2.10).

1       **Q:    What is the revenue requirement impact of adjustments PC-E 3.02 and PC-G**  
2       **3.00?**

3       A:    As shown on Schedule No. 2 of Exhibit No. JRD-2 and Exhibit No. JRD-3, the  
4       revenue requirement impact is \$950,000 and \$262,000 for electric and gas  
5       operations, respectively.

6       **Q:    The Company also proposes pro forma electric and gas operations**  
7       **adjustments for “Executive Labor.” Are you proposing revisions to the**  
8       **Company’s Executive Labor adjustments to eliminate anticipated 2015**  
9       **increases?**

10      A:    No, such revisions were not necessary regarding the Company’s pro forma  
11      expense adjustments for “Executive Labor.” While the Company does propose  
12      pro forma “Executive Labor” Adjustment Nos. 3.03 and 3.01 for electric and gas  
13      operations, respectively, such adjustment only capture slight shifts in the  
14      allocation of executive labor between utility and non-utility operations.<sup>37</sup> The  
15      Company did not include any estimate for 2015 executive wage increases within  
16      the noted adjustments and accordingly, no revision to eliminate 2015-estimated  
17      wage increases for executives was required.

18      **Q:    Please continue by discussing your next proposed modification to Avista-**  
19      **proposed pro forma expense adjustments.**

20      A:    I am proposing modifications to Company Adjustment Nos. 3.04 and 3.02 for  
21      electric and gas operations, respectively. Avista’s Adjustment Nos. 3.04 (electric)

1 and 3.02 (gas) were calculated by considering 2014 actuarial experience for  
2 employee health and medical benefits, as well as actuarially estimated 2015  
3 pensions and post-retirement medical benefits (PRMB) expense. I am proposing  
4 to modify the noted employee benefits expense adjustments to only reflect  
5 actuarially determined pensions and PRMB costs for 2014 that the Company is  
6 currently recording. The revenue requirement value of Adjustment PC-E.-3.02  
7 for electric operations is \$2,361,000 and the revenue requirement value of  
8 Adjustment PC-G.3.02 for gas operations is \$653,000.

9 **Q: Does the entire difference in revenue requirements between yours and the**  
10 **Company's employee benefits adjustment stem from your proposed**  
11 **reflection of 2014 actuarially determined pension and PRMB expense versus**  
12 **the Company's reflection of 2015 actuarially estimated pension and PRMB**  
13 **expense?**

14 A: No. Beyond just conceptually opposing the Company's proposed reflection of  
15 another 2015 estimate of expense levels, I note that the Company has received  
16 revised actuarial estimates for pensions and PRMB expense for 2014 and 2015  
17 that are significantly lower than estimates that the Company was relying upon  
18 when originally preparing Company Adjustment Nos. 3.04 and 3.02 for electric  
19 and gas operations, respectively.<sup>37</sup> Thus, the fairly large differences in revenue  
20 requirements stated above attributable to these employee benefits adjustments is

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<sup>37</sup> I am taking no position with regard to the Company proposed proforma shift in executive salaries between utility and non-utility operations. Accordingly, on Exhibit Nos. JRD-2 and JRD-3, the Company adjustments for Pro Forma Executive Labor are designated as "PC Neutral."

<sup>38</sup> Avista's response to Public Counsel Data Request No. 213.



1 due in part to my proposed rejection of the Company's reflection of 2015  
2 estimates for pensions and PRMB expense, but also due in large part to the lower  
3 estimates for pensions and PRMB expense that Avista has been presented  
4 subsequent to preparing its initial pro formal employee benefits expense  
5 adjustment.

6 In response to Public Counsel Data Request No. 213, Avista provided the  
7 revised 2014 and 2015 pension and PRMB cost estimates and also indicated its  
8 intentions to revise its Company Adjustment Nos. 3.04 and 3.02 for electric and  
9 gas operations, respectively, to reflect new estimates being provided for 2015.

10 Thus, while the true revenue requirement difference between Public Counsel and  
11 Avista for these employee benefits adjustments will be less than that stated above  
12 once Avista's revises its revenue requirement schedules, a difference will  
13 nonetheless continue to exist inasmuch as Avista continues to support reflection  
14 of a 2015 estimate.<sup>39</sup>

15 **Q: Please continue by discussing your next proposed modification to a pro**  
16 **forma expense adjustment as calculated by Avista.**

17 A: Avista proposes proforma adjustment 3.05 and 3.03 for electric and gas  
18 operations, respectively, to reflect 2015 estimated increases for General Liability  
19 and Directors and Officers Liability insurance expense. Avista estimated that  
20 2014 insurance premiums would be increased by 10.0 percent in 2015 and that

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<sup>39</sup> While the revenue requirement difference attributable to employee benefits expense differences will change whenever Avista updates its schedules, Avista actual requested rate relief is not expected to change. Specifically, it is anticipated that any change in pro forma employee benefits expense will be accompanied

1 2014 Directors and Officers Liability insurance expense would be increased by  
2 5.0 percent in 2015. I am opposing reflection of the 2015 estimated increases as  
3 they are not “known and measurable,” and because to reach that far beyond the  
4 end of the historic test period creates a test year mismatch in the measurement of  
5 annualized/normalized revenues and expense, and the cutoff measurement date  
6 for rate base valuation. Accordingly, with adjustment PC-E.3.05 and PC-G 3.03,  
7 I propose pro forma insurance expense levels revised to eliminate the 2015  
8 estimated increases being proposed by Avista. The revenue requirement impact  
9 of adjustment PC-E 3.05 is \$445,000 and the revenue requirement impact of  
10 adjustment PC-G 3.03 is \$119,000.

11 **Q: Please continue with your next recommended modification to Company-**  
12 **proposed pro forma expense adjustments.**

13 A: Avista estimated 2015 property tax expense for electric and gas operations by  
14 considering budgeted Plant in Service balances at December 31, 2014 – or  
15 effectively what Avista would consider the start of the first “rate year.” Avista  
16 also provided an estimate of 2014 property tax expense for both its electric and  
17 gas operations. I have accepted Avista’s estimate of 2014 property tax expense  
18 that was calculated by considering end of 2013 Plant in Service balances. My  
19 revised pro forma adjustment for insurance expense has been designated as PC-E  
20 3.06 and PC-G 3.04 for electric and gas operations, respectively. The revenue  
21 requirement impact of electric operations pro forma property tax expense as

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by an equal offsetting change in the “plug” adjustment Avista posts to always force the sum of restating and pro forma adjustment to equal its attrition request.

1 shown on adjustment PC-E 3.06 is \$1,130,000 and the revenue requirement  
2 impact of gas operations pro forma property tax expense as shown on PC-G 3.04  
3 is \$201,000.

4 **Q: You have discussed your proposed revisions to four Avista-proposed pro**  
5 **forma expense adjustments wherein you effectively remove 2015 estimated**  
6 **cost increases as calculated by Avista. Does your removal and opposition to**  
7 **the Company-proposed reflection of 2015 estimated increases automatically**  
8 **translate to some form of “disallowance,” or significantly expose Avista to**  
9 **under recovery of such costs?**

10 A: Not at all. First, the magnitude of 2015 estimated expense increases is not known  
11 or fully measurable at this time. Second, even if the Avista-estimated increases  
12 are experienced in 2015, they may be “offset” by events such as customer margin  
13 growth beyond March 2014 (i.e., the cutoff reflected in Public Counsel’s revenue  
14 normalization adjustments), or any other cost cutting measures that could be  
15 invoked by the Company. Finally, rates can be reset on an accelerated timeline  
16 and within a non-controversial ERF proceeding – so long as Avista makes such  
17 filing following this Commission’s most recent precedent for Avista. In short,  
18 rejection of Avista’s estimated 2015 increases in expense does not automatically  
19 translate to a “disallowance” or under recovery of costs because those costs can  
20 be timely recovered once they are known and measurable.

21

1           **IX. REVISIONS TO AVISTA-PROPOSED FEDERAL INCOME TAX**  
2           **RESTATING ADJUSTMENT [Exhibit No. JRD-2, Schedule No. 2,**  
3           **Adjustment PC-E. 2.06 and Exhibit No. JRD-3, Schedule No. 2, Adjustment**  
4           **PC-G.2.06]]**  
5

6           **Q: Are you proposing revisions to any of Avista’s test year restating**  
7           **adjustments?**

8           A: My review of Avista’s restating adjustments was limited. That stated, I am  
9           proposing one revision to Avista’s adjustment calculated to restate federal income  
10          tax expense that is applicable to both electric and gas operations, as well as one  
11          other revision to Avista’s federal income tax expense adjustment that is only  
12          applicable to electric operations.

13          **Q: Please discuss and describe the one revision you are proposing to Avista’s**  
14          **federal income tax expense restating adjustment that is applicable to both**  
15          **electric and gas operations.**

16          A. I am proposing that Avista’s electric and gas operations federal income tax  
17          restating expense adjustment be modified to reflect a recurring permanent  
18          book/tax difference that is available to Avista to consistently reduce current  
19          federal income tax expense. Specifically, I am proposing that the permanent  
20          book/tax difference referred to as the “Employee Stock Ownership Plan Dividend  
21          Deduction” be included in the calculation of restated current federal income tax  
22          expense.

23          **Q: What is a “permanent” book/tax difference?**

24          A: A “permanent” book/tax difference can occur or arise whenever either: 1) a  
25          transaction is recognized for “book” or “financial statement” earnings

1 presentation purposes that is *never* recognized for purposes of calculating federal  
2 taxable income or 2) a transaction is recognized for purposes of calculating  
3 federal taxable income that is *never* recognized for “book” or “financial  
4 statement” earnings presentation purposes. An example of a permanent book/tax  
5 difference that many individual tax payers can relate to is the receipt of interest on  
6 municipal bonds that most definitely represents income to an individual bond  
7 holder that is never considered income for purposes of calculating federal taxable  
8 income.

9 **Q: What events or transactions give rise to the permanent book/tax difference**  
10 **you have referred to as the Employee Stock Ownership Plan Dividend**  
11 **Deduction (ESOP dividend deduction)?**

12 A: Avista employees are permitted to purchase Company stock within their 401-K  
13 employee benefits plan. Dividends paid on common stock issued by a corporate  
14 tax payer are never recorded as an “expense” for financial statement earnings  
15 presentation, and are *normally never* deducted for purposes of calculating  
16 corporate federal taxable income. The exception to the “normal” situation  
17 wherein dividends paid on corporate common stock are *not deductible* for  
18 purposes of calculating corporate federal taxable income occurs when dividends  
19 are paid on common stocks held within the employees’ 401-K plan. When  
20 dividends are paid on common stock held in the employees’ 401-K plan, such  
21 dividends become tax deductible to the corporate tax payer even though such  
22 dividend payments are never reflected as an “expense” for financial statement  
23 earning development. Thus, dividends paid on common stock held in employees’

1 401-K plan create, or result in, a permanent book/tax difference that on a regular,  
2 consistent and ongoing basis reduces Avista’s corporate federal taxable income  
3 and attendant corporate federal current income tax expense.

4 **Q: How has Avista treated or reflected the ESOP dividend deduction in the**  
5 **calculation of current federal income tax expense reflected for retail cost of**  
6 **service development?**

7 A: Avista has designated the ESOP dividend deduction as a “non-operating” or “non-  
8 utility deduction.” As such, Avista does not allocate or assign any portion of the  
9 ESOP dividend deduction to utility operations. The outcome of such position is  
10 that this permanent ongoing federal tax deduction – and attendant savings – are  
11 allocated 100 percent to shareholders.

12 **Q: Why does Avista assign 100 percent of this permanent tax deduction to**  
13 **shareholders?**

14 A: This question was posed as elements of Public Counsel Data Request No. 191  
15 which dealt exclusively with the topic of the ESOP dividend deduction. In  
16 subparts (g) and (h) to Public Counsel Data Request No. 191 Avista was asked:

- 17 (g) To the extent not fully addressed in response to other subparts of  
18 this request, please state/describe all reason why this permanent  
19 difference is designated as a “non-operating” difference.  
20 (h) To the extent not fully addressed in response to other subparts of  
21 this request, please state/describe all reason why this permanent  
22 difference should not be allocated/assigned at least in part to utility  
23 operations.  
24  
25

26

1 The Company's complete response to inquiries set forth with in subparts (g) and  
2 (h) of Public Counsel Data Request No. 191 stated:

3 (g) The federal tax deduction is associated with a common stock  
4 dividend distribution to an employee shareholder for shares held in  
5 a non-utility trust, and is not included in utility rate base [SIC].  
6 Common stock dividends are not specific components of utility  
7 income or the associated revenue requirement.

8 (h) Company contributions to the employee 401-k plan are properly  
9 accounted for as employee benefit costs and included in financial  
10 and regulatory accounting as recoverable costs of utility service.  
11 Costs of common equity, however, are recovered through the cost  
12 of common equity component of the authorized rates of return  
13 approved by the utility commissions where the company serves.  
14 As noted in the response to (g) above, company common stock  
15 dividends issued to shares are held in a separate trust, wherein  
16 employees maintain ownership, among other options, of company  
17 stock for their individual use, and is not a component of utility  
18 cost of service; it is a component of the authorized rate of return.  
19

20 I have also attached as Exhibit No. JRD-7 the Company's complete response to  
21 all components of Public Counsel Data Request No. 191.

22 **Q: Do you find the Company's arguments for allocating 100 percent of this**  
23 **permanent tax deduction to shareholders persuasive?**

24 A: No. First, the Company's 401-K Plan is an employee benefit – with any  
25 associated expense being routinely, and to my knowledge, without exception fully  
26 included in the development of Washington retail electric and gas base rates.  
27 Second, I take strong exception to Avista's statement that dividends issued for  
28 shares held in the 401-K trust accounts are “not a component of utility cost of  
29 service.” As this Commission knows very well, a return on common equity is  
30 always included in the development of a regulated utility's weighted overall cost  
31 of capital – and rates are always developed by including an allowance for return

1 on rate base that is calculated by multiplying the utility's overall cost of capital  
2 times its rate base investment. While dividends are typically not separately set  
3 forth as a component of the return on equity (ROE), under the discounted cash  
4 flow (DCF) methodology that I understand this Commission regularly adheres to  
5 in the setting of ROE, dividends along with expected growth in earnings form the  
6 basis of establishing the targeted or desired ROE. Thus, to suggest or imply that  
7 dividends paid on shares of common stock – whether held in a 401-K trust  
8 account or any other type of financial account – are not included as a component  
9 of a utility's cost of service is disingenuous.

10 **Q: Is the payment of common stock dividends mandatory?**

11 A: No. While it is true that common stock dividends are issued at the discretion of  
12 the utility's Board of Directors, they are typically consistently paid – with the  
13 cutting or elimination of a utility common stock dividend being a very infrequent  
14 occurrence. Further, as noted in the Company's response to subpart (f) of Public  
15 Counsel Data Request No. 191 (Exhibit No. JRD-7), Avista experienced constant  
16 to slightly-increasing ESOP dividend deductions for years 2010 through 2013 and  
17 estimates identical deductions for years 2014 and 2015. Thus, to suggest that  
18 such deduction is not reasonably known and measurable, even though it is  
19 technically "discretionary," is also unsupportable.

20 **Q: Can a credible argument be made that somehow Avista's shareholders,**  
21 **rather than its ratepayers, are entitled to savings resulting from this**  
22 **permanent book/tax deduction that Avista routinely takes on its corporate**  
23 **federal income tax return?**



1       A:     No. Avista’s rates have been, and almost certainly will continue to be, established  
2             by considering a targeted ROE that includes an ongoing dividend component. If  
3             the savings from permanent ESOP dividend deduction is assigned to shareholders  
4             – as Avista proposes – rates will be established with a targeted ROE that does not  
5             consider all tax savings available to Avista. In short, the Company effectively  
6             argues by its rate treatment proposed for the ESOP dividend deduction, that  
7             shareholders should be entitled to a targeted ROE *plus additional earnings*  
8             generated by savings resulting from the ESOP dividend deduction that is not  
9             being considered in Washington rate development. If Avista were to reduce its  
10            otherwise-requested targeted ROE for tax savings achieved by virtue of the ESOP  
11            dividend deduction, I would agree that ratepayers should not be entitled to such  
12            tax savings. However, Avista proposes no such reduction to its otherwise-  
13            requested ROE for tax savings being realized from taking the ESOP dividend  
14            deduction.

15       **Q:     Please discuss how you have revised Avista’s restating adjustments for**  
16             **corporate federal income to reflect savings generated from the ESOP**  
17             **dividend deduction.**

18       A:     My revisions to the Company’s restating corporate federal income tax expense  
19             adjustments are found on adjustments PC-E 2.06 and PC-G 2.06. As reflected  
20             within footnote (1) found on each adjustment schedule, I started with a “total  
21             Avista” ESOP dividend deduction of \$1,484,424 million – an amount actually  
22             expected to be deducted by Avista for tax year 2013, and virtually identical to the  
23             \$1.5 million predicted by Avista to be taken for tax years 2014 and 2015. I

1 allocated 98.8 percent of the total \$1.5 million deduction to Avista’s utility  
2 operations – consistent with Avista’s allocation of total corporate employee  
3 benefits to utility operations. I then allocated the total utility ESOP divided  
4 deduction to Washington electric and gas operations on the basis of Washington  
5 O&M labor to total utility O&M labor for all Avista utility jurisdictions. The  
6 impact of the noted revisions attributable to reflecting tax savings generated by  
7 the ESOP dividend deduction is to reduce Washington electric operations revenue  
8 requirements by \$386,000 and reduce Washington gas operations revenue  
9 requirements by \$107,000.

10 **Q: Please continue by discussing your final revision to electric operations**  
11 **restated federal corporate income tax expense.**

12 A: My next adjustments revises test year federal income tax expense to reflect the  
13 actual Domestic Production Activities Deduction (DPAD) now expected to be  
14 taken for the 2013 tax year. When calculating “recorded” current income tax  
15 expense for the historic test year ending June 30, 2012, the Company utilized a  
16 total Company DPAD estimate of \$3,000,000 that was considerably lower than  
17 the DPAD amount that was actually claimed for calendar year 2012 or the amount  
18 now calculated and expected to be taken when filing its 2013 corporate income  
19 tax return. Thus, the impact of my revision to Avista’s electric operations  
20 restating adjustment as reflected on PC-E 2.06 is to lower test year federal  
21 income tax expense to reflect the larger DPAD expected to be taken for tax year  
22 2013.

1       **Q: Why is it appropriate to reflect the noted revision to the Company’s**  
2       **proposed test year DPAD included within its electric operations restating**  
3       **adjustment for test year corporate federal income tax expense?**

4       A: In response to Public Counsel Data Request No. 98 Avista provided the following  
5       DPAD deductions for years 2011, 2012 and 2013:

6	2011 Actual	\$6,296,845
7	2012 Actual	\$4,009,808
8	2013 Estimated	\$5,650,000

9       It is unclear why the Company elected to reflect a lower DPAD than was actually  
10       taken for 2012, much lower than what it claimed for 2011, and also much lower  
11       than the amount it now calculates to be taken for calendar year 2013. In any  
12       event, the “unadjusted” DPAD included in the Company’s income tax restating  
13       adjustment is clearly unsupported and in need of upward revision. I am  
14       recommending inclusion of the DPAD expected to be taken in 2013 as I believe  
15       reflection of the estimated 2013 DPAD in development of the Company’s electric  
16       operations is better synchronized with adjusted test year operating results, and  
17       probably represents a conservative estimate of the DPAD to be taken during the  
18       rate effective period.

19       **Q: Please explain your last conclusion regarding the reasonableness of the**  
20       **DPAD amount you are proposing to include in electric operations revenue**  
21       **requirements.**



1           A:    My major conclusions and recommendations regarding the Company's claim of  
2                    regulatory lag and its request for an attrition adjustment for both electric and  
3                    natural gas operations are as follows:

4                    •    I am recommending that the Company's attrition adjustments be rejected in  
5                            this docket. However, in recognition of a need to address regulatory lag,  
6                            potential earnings erosion, and fatigue resulting from nearly annual GRC  
7                            filings, I am recommending that 1) rates established in this GRC be  
8                            developed by including post-test year updated rate base values, and 2) Avista  
9                            be permitted to undertake two ERFs with relatively few restrictions as to test  
10                          years to be employed or filing intervals before base rates are again  
11                          established with a comprehensive GRC filing.

12                  •    My reasons for rejection of the Company's proposed attrition adjustment  
13                          include:

14                          ○    No guidance or directive has yet been given by this Commission as to  
15                                  what conditions should exist before an attrition adjustment is to be  
16                                  considered. Further, no guidance or directive has been given as to how  
17                                  an attrition should be properly constructed.

18                          ○    The Company's mix-and-match approach to developing its proposed  
19                                  attrition adjustment in the current, as well as the prior, GRC suggest  
20                                  developing a properly constructed attrition adjustment will likely  
21                                  prove difficult, controversial and confusing. Specifically, in  
22                                  developing its proposed attrition adjustment the Company has: 1)

- 1 selected an historic trend period that supports the very recently  
2 accelerated construction program it is electing to embark upon, 2) used  
3 Company budgets to develop “rate year” margins or revenues, and 3)  
4 used judgment to develop its proposed O&M expense escalator.
- 5 ○ Avista’s recent decision to significantly accelerate its construction  
6 program shortly following implementation of rates that were primarily  
7 developed by reflecting a very significant attrition adjustment suggest  
8 it is reasonable to question whether the granting of an attrition  
9 adjustment has resulted in the unintended consequence of promoting  
10 utility investment – rather than inspiring utility managers to control  
11 costs aggressively to achieve the lowest reasonable cost of service - as  
12 the Staff recently argued should be expected when a degree of  
13 regulatory lag is experienced.
  - 14 ○ A number of other options that continue to rely upon historic test year  
15 ratemaking conventions – including utilization of ERFs – have not  
16 been fully explored or tested as a means of addressing regulatory lag,  
17 earnings erosions, or the fatigue attendant to undertaking frequent  
18 GRC reviews.
  - 19 ● The various means for addressing regulatory lag that I am proposing, that  
20 adhere to reflecting “known and measurable” changes and utilization of  
21 historic test year mechanisms, include:

- 1                   ○ Developing major rate base components by including EOP rather than  
2                   AMA valuations.
- 3                   ○ Reflecting pro forma adjustments that reflect post-test year prices and  
4                   conditions, but nonetheless are restricted to “known and measurable”  
5                   events or conditions.
- 6                   ○ When possible and practical, reflecting post-test year updates for Net  
7                   Plant After Deferred Income Taxes values available closer to the rate  
8                   effective date, albeit with corollary adjustments to update for known  
9                   “offsets” for items such as revenue growth to a similar cutoff point in  
10                  time.
- 11                  ○ Authority to file up to two ERFs with few limitations or restrictions  
12                  regarding test years to employ or minimum intervals between filings.

13                  In summary, I respectfully request that the Commission revisit its willingness to  
14                  grant a significant attrition adjustment, and instead, adopt the various other  
15                  approaches and mechanisms I have recommended herein as a means of  
16                  combatting regulatory lag, potential earnings erosions and rate case fatigue.

17                  **Q: Does this conclude your direct testimony?**

18                  A: Yes, it does.