

Exhibit No. ____ -T (DPK-1T)
Docket Nos. UE-070804 et al.
Witness: Danny P. Kermode

**BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Complainant,

vs.

AVISTA CORPORATION

Respondent.

DOCKET NO.UE-070804

DOCKET NO.UG-070805

DOCKET NO. UE-070311

In the Matter of the Petition of

**AVISTA CORPORATION d/b/a
AVISTA UTILITIES,**

For an Accounting Order Regarding the
Appropriate Treatment of the Net Costs
Associated with the Purchase of Debt.

TESTIMONY OF

Danny P. Kermode

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Results of Operations

October 17, 2007

1 **I. INTRODUCTION.**

2

3 **Q. Please state your name and business address.**

4 A. My name is Danny P. Kermode. My business address is the Richard Hemstad Building,
5 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington
6 98504. My email address is dkermode@utc.wa.gov.

7

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

9 A. I am employed by the Washington Utilities and Transportation Commission as a
10 Regulatory Analyst.

11

12 **Q. How long have you been employed by the Commission?**

13 A. I have been employed by the Commission for 11 years.

14

15 **Q. Would you please describe your educational background?**

16 A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a Bachelor of
17 Science in Accounting. Later that same year, I attended San Carlos University in the
18 Philippines for postgraduate studies in economic analysis and quantitative business
19 analysis. I am licensed in Washington as a Certified Public Accountant (CPA).

20 In 1992 and 1993, I was a member of the faculty at the National Association of
21 Regulatory Utility Commissioners (NARUC) Annual Regulatory Studies Program, held

1 at Michigan State University in East Lansing, Michigan. I taught classes in Financial and
2 Regulatory Accounting Standards and in Deferred Tax Accounting.

3 In 2002, I published an article in the Journal of the American Water Works
4 Association, titled *Contributions in Aid of Construction: IRS Final Regulations* (2002). I
5 later published an article in the National Regulatory Research Institute's Journal of
6 Applied Regulation, titled *Regulatory Provision of Income Taxes for S Corporations and*
7 *Other Nontaxable Business Forms* (2004).

8
9 **Q. Please discuss your professional background.**

10 A. I am a financial professional with a CPA and 20-plus years experience that includes
11 experience in private practice, industry, and government. I spent 10 years as a CPA in
12 private practice in Phoenix, Arizona, from 1983 to 1993, where I was an expert witness in
13 a number of utility cases before the Arizona Corporation Commission, the state's public
14 utility regulatory body.

15 From 1994 to 1996, I was the controller for the Rocky Mountain Institute, a large
16 internationally-recognized non-profit organization that conducts research and performs
17 services in the energy field. Since 1996, I have been employed by the Washington
18 Utilities and Transportation Commission ("the Commission") as a Regulatory Analyst.

19 Since my employment at the Commission, I have testified in numerous cases
20 including testifying in the last three PacifiCorp general rate cases, Dockets UE-032065,
21 UE-050684, and UE-061546. I testified on accounting and income tax issues in the 2001
22 rate case involving Olympic Pipeline Company, Docket No. TO-011472. I also filed

1 testimony in four water company general rate cases: American Water Resources, Docket
2 No. UW-980258; Rainier View Water Co., Inc, Docket No. UW-010877; Marbello Water
3 Company, Docket No. UW-041181, and Iliad Water Service, Inc., Docket No. UW-
4 060343. I filed testimony regarding income taxes in the Verizon Northwest, Inc. general
5 rate case, Docket No. UT-040788.

6
7 **II. SCOPE OF TESTIMONY.**
8

9 **Q. What is the scope of your testimony?**

10 A. My testimony and exhibits reflect the results of Staff's analysis of Avista Corporation's
11 ("Avista" or "Company") test year results of operations, rate base, and capital structure
12 for Avista's electric operations and its natural gas operations. The Staff results reflect
13 restating adjustments and pro forma, known and measurable changes. My testimony
14 identifies Company proposed adjustments which Staff reviewed and does not contest,
15 adjustments resolved in the partial settlement, and the adjustments that remain contested.
16 Adjustments and analyses of other Staff witnesses are incorporated into my results of
17 operations, rate base, and capital structure for both the Company's electric operations and
18 its natural gas operations.

19 As the lead regulatory analyst for this case, it is my responsibility to present and
20 explain Staff's pro forma results of operations. I will present among other things, the
21 computation of revenue conversion factor along with the derivation of Staff's
22 recommended revenue requirement for both the electric and gas operations.

1
2 **Q. Have you prepared any exhibits in support of your testimony?**

3 A. Yes. I have prepared Exhibit No. ____ (DPK-2) and Exhibit No. ____ (DPK-3). Both are
4 multi-page exhibits that show Avista's 2006 operating results for its Washington Electric
5 Operations and Washington Natural Gas Operations, respectively. Included in Exhibit
6 Nos. ____ (DPK-2) and (DPK- 3) are:

- 7 • Results of Operations Summary - (Schedule 1.1);
- 8 • Schedule of Restating Adjustments - (Schedule 1.2);
- 9 • Schedule of Pro forma Adjustments - (Schedule 1.3);
- 10 • Summary of Adjustments;
- 11 • Revenue Requirement Computation;
- 12 • Revenue Conversion Factor;
- 13 • Pro Forma Capital Structure and Cost of Capital.

14
15 I also prepared the following exhibits in support of my calculations and adjustments:

- 16 • Exhibit No. ____ (DPK-4), Pro Forma Interest Adjustment – Electric;
- 17 • Exhibit No. ____ (DPK-5), Production Property Adjustment Calculation – Electric;
- 18 • Exhibit No. ____ (DPK-6), Adjustment to Incentive Compensation – Electric and
19 Gas;
- 20 • Exhibit No. ____ (DPK-7), Pro Forma Interest Adjustment – Gas.

David C. Parcell, Exhibit No. ____ -T (DCP-IT)) and Ken Elgin for the cost of debt and the cost of trust preferred securities (See direct testimony of Kenneth L. Elgin, Exhibit No. ____ -T (KLE-IT)). The calculation of Staff's recommended rate of return is shown on the last page of Exhibit No. ____ (DPK-2) for Avista's electric operations and the last page of Exhibit No. ____ (DPK-3) for Avista's gas operations.

IV. DISCUSSION.

Q. Would you please identify the areas that you will discuss in your testimony regarding results of operations?

A. I testify to Staff's recommended revenue requirement for Avista's Washington's electric and gas operations, as shown on Exhibit No. ____ (DPK-2), Electric- Results of Operations, and Exhibit No. ____ (DPK-3), Gas- Results of Operations. These exhibits show actual and pro forma results of operations along with the impact of Staff's recommended revenue requirement. I also provide additional schedules that provide support for the results. In addition, adjustments from other Staff witnesses are incorporated into the exhibits.

Q. Will you discuss the effect of the partial settlement agreement on Staff's recommendation presented in your Results of Operations?

A. Yes. I briefly discuss some of the adjustments in the partial settlement reached by Staff and the other parties to the case. I also provide a listing of the adjustments that were

1 resolved in the agreement. In addition, I also provide for the record, testimony on the
2 following five settled adjustments to provide a complete record of the adjustments and
3 the reasoning behind them. The settled adjustments are:

- 4 • R-1, *Deferred FIT Rate Base*, Electric and Gas;
- 5 • R-2, *Deferred Gain on Office Building*, Electric and Gas; and
- 6 • R-22 (Electric) and R-14 (Gas) *Incentive Compensation Adjustment*.
- 7 • PF-2, *Production Property Adjustment*, Electric;
- 8 • PR-10, *Miscellaneous Adjustments*, Electric.

9
10 **Q. Are there any remaining issues not resolved in the settlement agreement pertaining**
11 **to the calculation of the revenue requirements?**

12 A. Yes. The remaining issues not resolved in the settlement agreement for the calculation of
13 Avista's electric operations revenue requirement are:

- 14 • Restating Adjustment R-25 *Customer Deposits*;
- 15 • Pro forma capital structure; and
- 16 • Cost of capital and cost of debt.

17 For Avista's gas operations, the only remaining issues contested related to its revenue
18 requirement are:

- 19 • Restating Adjustment R-19 *Customer Deposits*;
- 20 • Pro forma capital structure; and
- 21 • Cost of capital and cost of debt.

1

2 **Q. Will you be presenting any testimony regarding any of the unsettled issues?**

3 A. Yes. Of the remaining contested issues, I provide testimony supporting Staff's
4 adjustment for the regulatory treatment of Customer Deposits, shown as Staff Restating
5 Adjustment R-25, *Customer Deposits*.

6

7 **Q. In addition to incorporating the adjustments and analyses of other witnesses**
8 **testifying on behalf of Commission Staff, what specific adjustments were you**
9 **responsible for?**

10 A. I was responsible for the following Company adjustments:

- 11 • Deferred FIT Rate Base (electric and gas);
- 12 • PGE Monetization (electric);
- 13 • Federal Income Tax (FIT) (electric and gas);
- 14 • Pro Forma Interest (electric and gas);
- 15 • Production Property Adjustment (electric).

16

17 **Q. Please give a brief overview of your Exhibit No. ____ (DPK-2), entitled “Avista**
18 **Corporation, Electric – Results of Operations, Twelve Months ended December 31,**
19 **2006.”**

20 A. Exhibit No. ____ (DPK-2) is a 14-page exhibit showing the Staff analysis of the
21 Company's results of operations for the 2006 test year. Page one of Exhibit No. ____

1 (DPK-2), labeled Schedule 1.1, presents the Results of Operations, Rate Base, and Return
2 on Investment (ROI) information. The company's Unadjusted Results are shown in
3 Column (b), Restated Results are shown in Column (d), and Pro forma Results are shown
4 in Column (f) with pro forma test year results adjusted for Staff proposed revenues shown
5 in Column (h).

6 Further, each restating amount shown in Column (c) is itemized on pages two to
7 seven of Exhibit No. ____ (DPK-2), labeled as schedule 1.2, using the same adjustment
8 titles as the Company uses in Elizabeth Andrews's Exhibit No. ____ (EMA-2). However,
9 for ease of reference, Staff has added restating adjustment numbers to the Company's
10 restating adjustments titles.

11 Each pro forma amount shown in Column (e) is itemized on pages seven to 10 of
12 Exhibit No. ____ (DPK-2), labeled Schedule 1.3. In addition to the Company's
13 adjustments, Schedules 1.2 and 1.3 reflect added adjustment numbers and titles for
14 Staff's adjustments.

15
16 **Q. Please explain more fully columns shown on page one of your Exhibit No. ____**
17 **(DPK-2).**

18 **A.** Page one of Exhibit No. ____ (DPK-2), labeled Schedule 1.1 Electric – Results of
19 Operations, has eight columns. Column (a), titled "Description," contains the account
20 descriptions.

21 The amounts shown in column (b) are the "per book" account balances for
22 Washington operations at year-end. The amounts reflected in this column are the same as

1 column (b) of Company witness Ms. Andrews's Exhibit No. ____ (EMA-2). Column (c)
2 reflects the total restating adjustments; these amounts are taken from column (b) on page
3 two Exhibit No. ____ (DPK-2) (Schedule 1.2). Column (d), titled "Restated Results,"
4 reflects the results from operations affected by the restating adjustments. Column (e)
5 reflects the total pro forma adjustments; these amounts are taken from column (b) of page
6 seven of Exhibit No. ____ (DPK-2) (Schedule 1.3). Column (f), titled "Pro Forma
7 Results," shows the restated results affected by known and measurable changes on a pro
8 forma basis. Column (g), titled "Staff Proposed," reflects the revenue and expense
9 impact at the Staff proposed increased revenue requirement.
10

11 **Q. Would your description of your Exhibit No. ____ (DPK-2) for Avista's electric**
12 **operations be the same for your Exhibit No. ____ (DPK-3) for Avista's Natural Gas**
13 **Operations?**

14 A. Yes, except Exhibit No. ____ (DPK-3) is entitled "Avista Corporation, Gas – Results of
15 Operations, Twelve Months ended December 31, 2006," and is a nine-page exhibit.
16

17 **Q. Please explain the difference between a restating adjustment and a pro forma**
18 **adjustment.**

19 A. As defined in WAC 480-09-330(2)(b)(i), restating actual adjustments (restating
20 adjustments) are those "adjustments which adjust the booked operating results for any
21 defects or infirmities which may exist in actual recorded results which can distort test

1 period earnings. Restating actual adjustments are also used to adjust from an as recorded
2 basis to a basis which is acceptable for ratemaking.”

3 WAC 480-09-330(2)(b)(ii) defines pro forma adjustments as “those adjustments
4 that give effect for the test period to all known and measurable changes that are not offset
5 by other factors.”
6

7 **Q. To avoid confusion, please discuss the Company’s adjustments and the labeling**
8 **convention it used to identify each of its adjustments.**

9 A. Avista’s accounting witness, Ms. Andrews, provided summary schedules of the
10 Company’s adjustments in her Exhibit No. ____ (EMA -2) for its electric operations and
11 Exhibit No. ____ (EMA -3) for its natural gas operations. For both sets of the Company’s
12 adjustments, the Company did not provide specific adjustment labels for its restating
13 adjustments. Rather, the Company refers to the adjustments by referring to the summary
14 schedule’s column letter or by the adjustment’s title. However, the Company does label
15 its pro forma adjustments as “PF” and the appropriate number such as PF1 for Pro Forma
16 Power Supply.
17

18 **Q. Describe Staff’s approach to labeling the Company’s adjustments.**

19 A. Avista’s use of column letters instead of adjustment labels has a potential of causing
20 confusion especially when citing restating adjustments. Although Staff routinely adopts
21 the Company’s labeling convention, Staff in this case has retained the title of the
22 company’s restating adjustment but labeled the adjustments using the common labeling

1 convention of “R-#” for Restating Adjustment with the appropriate number, for example
2 R-1 for Deferred FIT Rate Base. My Exhibit No. ____ (DPK-4) and Exhibit No. ____
3 (DPK-5), Summary of Adjustments, provide a comparison of the company’s column
4 label and Staff’s Restating Adjustment label in Column (a).

5
6 **IV. ADJUSTMENTS.**
7

8 **Q. Ms. Andrews provided summary schedules of the Company’s adjustments in her**
9 **Exhibit No. ____ (EMA -2) for its electric operations and Exhibit No. ____ (EMA -3)**
10 **for its natural gas operations. Does Staff accept any of the Company’s proposed**
11 **adjustments?**

12 **A.** Yes. Staff accepts many of Avista’s proposed adjustments. In my Summary of
13 Adjustments - Electric Operations, found in Exhibit No. ____ (DPK-2), page 11, and
14 Summary of Adjustments - Gas Operations, found in Exhibit No. ____ (DPK-3), page six,
15 uncontested adjustments are indicated with the letter “U” in column (a). Staff examined
16 these adjustments, conducted discovery, and concluded that each of the adjustments
17 marked with a “U” (Uncontested) is reasonable in principle and calculation and, where
18 applicable, consistent with prior Commission orders.

19 The following tables reflect the uncontested adjustments for Avista’s Washington
20 operations:

Table 1 – Uncontested Adjustments Electric Operations

R-2 (d)	Deferred Gain on Office Building	R-16 (r)	Nez Perce Settlement Adjustment
R-3 (e)	Colstrip 3 AFUDC Elimination	R-17 (s)	Eliminate A/R Expenses
R-4 (f)	Colstrip Common AFUDC	R-18 (t)	Office Space Charges to Subsidiaries
R-5 (g)	Kettle Falls Disallow.	R-19 (u)	Restate Excise Taxes
R-6 (h)	Customer Advances	R-20 (v)	Net Gains/losses
R-7 (i)	PGE Monetization	R-21 (w)	Revenue Normalization
R-9 (k)	Eliminate B & O Taxes	R-23 (y)	Restate Debt Interest
R-10 (l)	Property Tax	PF-1	Power Supply
R-11 (m)	Uncollectible Expense	PF-2	Prod Property Adj.
R-12 (n)	Regulatory Expense	PF-3	Labor Non-Exec
R-13 (o)	Injuries and Damages	PF-5	Transmission Rev/Exp
R-14 (p)	Federal Income Tax	PF-6	Transmission Capital Add
R-15 (q)	Eliminate WA Power Cost Defer	PF-7	Generation Capital Add

Table 2 – Uncontested Adjustments Gas Operations

R-2 (d)	Deferred Gain on Office Building	R-9 (k)	Uncollectible. Expense
R-3 (e)	Gas Inventory	R-10 (l)	Regulatory Expense
R-4 (f)	Weatherization and DSM Investment	R-11 (m)	Injuries and Damages
R-5 (g)	Customer Advances	R-12 (n)	Federal Income Tax
R-6 (h)	Revenue Normalization & Gas Cost	R-13 (o)	Restate Debt Interest
R-7 (i)	Eliminate B & O Taxes	R-15 (q)	Net Gains/ Losses
R-8 (j)	Property Tax	R-16 (r)	Eliminate A/R Expenses

1 **Deferred Gain on Office Building, R-2 (Electric and Gas)**

2 **Q. Although this issue is listed as not contested, briefly describe adjustment R-2,**
3 **Deferred Gain on Office Building shown in column (d) of your schedule 1.2 in**
4 **Exhibit No. ____ (DPK-2) and your Exhibit No. ____ (DPK-3).**

5 A. This adjustment reduces rate base for both the electric operations and natural gas
6 operations by the unamortized gain on the sale of the Company's general office facility in
7 1986. Even though the Company has bought back the facility in 2005, it was agreed by
8 Staff and the Company agreed that it would be in the ratepayers' interest to continue the
9 amortization of the unamortized balance of the original gain until 2011, rather than
10 reduce the current basis in the newly repurchased facility and have the remaining
11 unrecovered gain spread over a 50-year period.

12
13 **Pro forma Production Property Adjustment, PF 2 (Electric)**

14 **Q. Although the pro forma Production Property Adjustment was also uncontested,**
15 **please discuss what this adjustment reflects.**

16 A. This adjustment reflects the application of a production factor to complete the pro
17 forming of production costs from the forward looking "rate year" (January 2008 to
18 December 2008) level back to the historic "test year" (January 2006 to December 2006)
19 amount. The production factor is the ratio of 2006 test period loads and the 2008 pro
20 forma rate year loads. In the determination of net power costs, rate year levels of
21 consumption are used, in contrast to Avista's use of test year levels of consumption in
22 prior rate cases. Likewise, the adjustment considers the associated power costs for the

1 future rate year. As that future rate year has a different level of consumption than the
2 normalized historic test period, the production factor is applied to the rate year amounts
3 to bring those pro forma rate year costs, on a unit basis, back to the historic test year for
4 proper matching and comparability of all costs used in the revenue requirement
5 determination.

6 Avista's application of a production factor to rate year power costs in an historical
7 test year setting is consistent with the provisions of the Settlement Agreement in Docket
8 No. UE-060181. Staff believes the application of a production factor to rate year power
9 costs is an appropriate adjustment to the electric pro forma results of operations for
10 ratemaking purposes.

11 The production property adjustment is uncontested by the parties. However, since
12 the level of cost elements subject to the production factor are dependent on other power
13 related ratemaking adjustments, this adjustment is a fallout adjustment that reflects
14 Staff's rate year power costs and related expenses and production rate base levels, which
15 may be different from the final cost inputs determined by the Commission. The impact
16 of this adjustment is shown in the Staff electric results of operation under column PF2 of
17 Exhibit No. ____ (DPK-2).

18
19 **Retail Revenue Credit-Allocation of Common Costs.**

20 **Q. Please briefly discuss this issue.**

21 A. The issue is whether or not it is appropriate to allocate common administrative and
22 general expenses to the retail revenue credit used to offset variations between the actual

1 and allowed net power costs due to load growth in the Company's Energy Recovery
2 Mechanism (ERM).

3
4 **Q. What does Staff recommend?**

5 A. Staff agrees with the Company that it is not appropriate to include common costs in the
6 retail revenue credit rate. This is the same position presented by Staff in Docket No. UE-
7 060181, concerning Avista's petition for continuation of the ERM. Staff's position was
8 premised on the intent of the ERM, which is to capture changes in net power supply
9 costs, not changes related to the common general cost function. Furthermore, the
10 addition of another layer of non-power costs to the retail revenue credit necessitates
11 increasing the baseline power costs by the same non-power cost components, which
12 inflates the magnitude of overall costs subject to the operation of the ERM and adds
13 unnecessary complexity to the mechanism.

14
15 **Q. Did the Company propose any adjustments that Staff examined and ultimately**
16 **contested?**

17 A. Yes. However, for the most part, the issues have been resolved through the partial
18 settlement agreed to by Staff and the other parties to the case.¹ The adjustments resolved
19 by the partial settlement are indicated by the letter "S" in column (a) on the Summary of
20 Adjustments - Electric Operations, Exhibit No. ____ (DPK-2), page 11, and Summary of

Adjustments - Gas Operations, Exhibit No. ____ (DPK-3), page 6. The Settled adjustments are listed below in Table 3 for Electric and Table 4 for Gas.

Table 3– Settled Adjustments - Electric Operations

R-1 (c)	Deferred FIT Rate Base	PF-4	Labor Exec.
R-8 (j)	Settlement Exchange Power	PF-8	Depreciation Study
R-22 (x)	Incentive & Other	PF-9	Wood Pole Test & Treatment
R-24	Adjustment Sec-199 Deduction	PF-10	Pro Forma Misc. Adjustments

Table 4-Settled Adjustments - Gas Operations

R-1 (c)	Deferred FIT Rate Base	PF-3	Depreciation Study
R-14 (p)	Incentive & Other	PF-4	Storage Contract Expiration
PF-2	Labor Executive.	PF-5	Pro Forma Misc. Adjustments

¹ The stipulating parties, in addition to Staff and the Company, are: Public Counsel, Industrial Customers of Northwest Utilities, Northwest Industrial Gas Users, and The Energy Project.

1 Deferred FIT Rate Base, R-1 (Electric and Gas)

2 **Q. Although the issue was resolved in the partial settlement cited above, would you**
3 **please more fully discuss the issue related to Restating Adjustment R-1, *Deferred***
4 ***FIT Rate Base* shown in column (c) of page 2 of both Exhibit ____ (DPK- 2) and**
5 **Exhibit ____ (DPK-3)?**

6 A. Restating adjustment R-1 is a Company proposed adjustment that reflects the effect of
7 income tax timing differences between regulatory basis and tax basis accounting for both
8 its electric operations and its natural gas operations. Although the Company did not
9 provide any direct testimony on this adjustment, the Company proposed using the
10 average-of-monthly-average balance basis for the test year accumulated deferred income
11 tax deduction from rate base, rather than the end-of-period deferred income tax balance.

12 *See Ms. Andrews's direct testimony, Exhibit ____ (EMA-1T) at 13:2-3.*
13

14 **Q. Does the change reflect a change in the usual Commission approach?**

15 A. Yes. It has been Commission policy since the late 1970s to use end-of-period
16 accumulated deferred income tax balance for the rate base deduction, even though
17 average of monthly averages was used for all other rate base components.² It has been
18 the Commission opinion that the use of the end-of-period balance while using a historical
19 average rate base was specifically allowed by the Internal Revenue Service regulations.³

² *Utilities & Transp. Comm'n v. General Telephone Company of the Northwest, Inc.*, Cause U-80-38, Third Supplemental Order (TK date) at 7.

³ Internal Revenue Service 26 CFR 1.167(l)-1(h)(6) Exclusion of Normalization Reserve from Rate Base.

1 Discussions with the Company indicate that Avista filed its case using average
2 accumulated deferred tax balance as its deduction for rate base because of its concern
3 regarding a recently issued IRS Private Letter Ruling (PLR). In September 2006, the
4 Internal Revenue Service issued a PLR (PLR 200651026) that found the regulatory use of
5 a multi-year average rate base and an end-of-period deferred tax reserve component was
6 a violation of normalization requirements.⁴

7
8 **Q. Please briefly discuss that Private Letter Ruling.**

9 A. The Private Letter Ruling had been requested by a regulated public utility. That
10 unidentified utility's state regulatory agency proposed to use a five-year average rate base
11 for "...most of the components of general common plant, rather than the end-of-test-year
12 balances" while still using end-of-test-year accumulated deferred tax and accumulated
13 depreciation for rate base determination.⁵ The IRS ruled that the five-year average and
14 end-of-test-year methods violate normalization requirements.

15

⁴ Internal Revenue Service Private Letter Ruling 200651026, September 05, 2006

⁵ *Id.* Page 2

1 **Q. Is it your opinion that this ruling is definitive for the methodology used by the**
2 **Commission?**

3 A. Although a private letter ruling cannot be used or cited as precedent, it can be used as
4 guidance on possible actions by the IRS.⁶ After reviewing this letter ruling, I believe the
5 circumstances of the letter ruling are similar enough to raise legitimate concern by Avista
6 that the traditional method used by the Commission may be found to be a violation of
7 normalization.

8
9 **Q. Does Staff expect any further clarification from the IRS regarding if the**
10 **Commission's use of an average rate base except for the use of an end-of-period**
11 **accumulated deferred tax deduction is consistent with the IRS normalization**
12 **requirements?**

13 A. Possibly. Puget Sound Energy filed with the IRS a private letter ruling request on
14 October 26, 2006. The private ruling request explicitly requests a ruling regarding
15 Washington's use of period-end deferred tax and average rate base. Review of recent
16 letter rulings indicates a response time of approximately one-year from the date of the
17 filing.

18

⁶ The IRS can revoke or modify a private letter ruling by, among other methods, issuing a revenue ruling or procedure, or by regulations. See Section 11 of the IRS Revenue Procedure 2005-1.

1 **Q. Is Staff changing its position as to the equity of using the end-of-period accumulated**
2 **deferred tax amount as a deduction for rate base?**

3 A. No. Staff believes the method historically used by the Commission is consistent with the
4 IRS normalization requirements. Staff also believes that applying the end-of-period
5 accumulated deferred tax balance correctly matches the benefits of the deferred taxes
6 received by the company with a benefits received by the customer. Therefore, it is
7 Staff's position that if the IRS rules that the end-of-period method used by the
8 Commission for accumulated deferred tax conforms to normalization requirements, the
9 Staff will immediately return to the end-of-period method of computing rate base.

10
11 **Q. What is the impact on revenue requirement by using average accumulated deferred**
12 **income taxes as a deduction for rate base rather than end-of-period accumulated**
13 **deferred income taxes?**

14 A. The use of average deferred tax rather than end-of-period results increases revenue
15 requirement by \$177,505 for electric operations, and the revenue requirement for gas
16 operations increases by \$112,592.

17
18 **Incentives and Other - R-22 (Electric) and R-14 (gas)**

19 **Q. Was the Company's adjustment to expense related to incentives contested in the**
20 **Staff analysis, but resolved in the settlement?**

21 A. Yes. After discussions with the Company, the parties in the case agreed to a settlement
22 amount for ratemaking purposes.

1
2 **Q. Why did you disagree with the Company's methodology regarding the Incentives**
3 **and Other (Electric & Gas) Adjustment?**

4 A. Avista's incentive payout for 2006 was the second highest incentive payout that the
5 Company has made over the past eight years. The Incentive payout from 1999 to 2006
6 varied from \$0 to \$5,864,642, according to the Company's response to Staff Data
7 Request #232 -Supplemental. Avista did not pay any incentive payout during two out of
8 the past eight years. It is my opinion that the test year's higher than normal incentive
9 compensation should not be included in the company's results of operations used to
10 determine rates but, rather, a levelized expense should be used instead.

11
12 **Q. Please explain the adjustments you made to the Incentives and Other Adjustment?**

13 A. I levelized the high and low incentive payouts by averaging the past eight years of
14 incentive payouts. I then used the same proportion used by Avista witness Ms. Andrews
15 in her workpaper labeled "Miscellaneous Incentive and Other" to allocate this amount to
16 Utility-Non Executive (67.30 percent) and Utility-Executive (32.70 percent). Ms.
17 Andrews's calculation also removed approximately 71.93 percent of the Utility-
18 Executive incentive related to earnings per share. I removed the same 71.93 percent of
19 Utility-Executive incentive related to earnings per share out of my calculated Utility-
20 Executive incentive.

1 **Q. What is your recommended level of Incentive payout for ratemaking purposes?**

2 A. The levelized incentive payout after removing incentives related to earnings per share is
3 \$2,224,015 for the total company. The recommended amount decreases Washington's
4 revenue requirement for electric and gas operations by \$1,051,000 and \$274,000,
5 respectively. Exhibit No. ____ (DPK-6) shows the detailed calculation of Staff
6 recommended level of incentive payout.

7
8 **Q. Was this the incentives portion of the Incentives & Executive Compensation in the**
9 **partial settlement?**

10 A. Yes. The parties agreed to the Staff adjustment as part of the settlement. The incentive
11 adjustment is combined with an adjustment to executive compensation sponsored by
12 Public Counsel. The total adjustment for Avista's electric operations in Issue 2, shown
13 on Appendix 1 of the Partial Settlement, is \$1,383,000. This amount consists of the
14 \$1,051,000 reduction in revenue requirement related to Staff's Incentive Adjustment R-
15 22 and a \$332,000 Public Counsel sponsored adjustment to executive compensation.

16 The total adjustment for the Avista's gas operations, shown in Issue 2 of
17 Appendix 1 of the Partial Settlement, is \$363,000. This amount consists of the \$274,000
18 reduction in revenue requirement related to Staff's Incentive Adjustment R-14 and an
19 \$87,000 Public Counsel-sponsored adjustment to executive compensation.

1 **Q. Are there remaining contested adjustments?**

2 A. Yes. For Avista's electric operations, there are three remaining issues, restating
3 adjustment R-25 *Customer Deposits*, the pro forma capital structure, and the cost of
4 capital. For Avista's gas operations, the same three issues remain contested.

5 The pro forma capital structure and cost of equity is discussed by David Parcell in
6 his testimony filed in this case, *Exhibit No. ____ -T (DCP-1T)*. Ken Elgin discusses his
7 analysis of the cost of debt and cost of trust preferred securities in his testimony filed in
8 this case, *Exhibit No. ____ -T (KLE-1T)*.

9 The Customer Deposits adjustment is a Staff proposed adjustment with no
10 company counterpart adjustment that deducts company held customer deposits from rate
11 base, while adding back the interest paid to customers by the company.

12
13 **Customer Deposits Adjustment**

14 **Q. Please discuss your adjustment to the Company's results of operations for customer**
15 **deposits.**

16 A. This adjustment reduces the Washington jurisdictional rate base for electric and gas
17 operations by the average of monthly average balance of customer deposits. In addition
18 to rate base reduction by the amount of customer deposits, this adjustment treats the test
19 year associated interest expense as an above-the-line item for ratemaking purposes. The
20 effect of the rate base reduction is to recognize that a portion of rate base is funded by the
21 customer deposits which cost less than the Company's overall cost of capital. The
22 operating expense treatment of the interest paid by the Company recognizes the actual

1 cost associated with such deposits that will be shouldered by the general body of
2 customers that benefit from the rate base reduction.

3
4 **Q. What is the current rate of interest on deposits?**

5 A. The interest rate for 2007 is 5.06 percent; this compares with the test year 2006 rate of
6 4.42 percent. The higher 5.06 percent rate was factored into the calculation of the
7 adjustment to increase operating expenses by the cost of the interest paid on the deposits.

8
9 **Q. How is the customer deposit interest rate determined?**

10 A. The rate is set yearly in accordance with the provisions of WAC 480-100-113(9) and
11 WAC 480-100-118(6) for electric residential and non-residential customers, respectively.
12 WAC 480-90-113(9) and WAC 480-90-118(6) are used for gas residential and non-
13 residential customers, respectively. That rate is set based on the one-year Treasury
14 Constant Maturity calculated by the U.S. Treasury, as published on January 15 of a
15 particular year.

16
17 **Q. Why should the Commission accept Staff's adjustment?**

18 A. The Commission should accept Staff's adjustment because it is fair to both the customers
19 and the Company. On one hand, customers get credited for the cheaper funds available
20 for the Company's use, and the direct rate base deduction ensures that the customer
21 provided funds do not benefit non-utility operations. On the other hand, the Company

1 remains whole by inclusion of the actual interest paid on deposits as an operating
2 expense.

3
4 **Q. Has this Commission accepted Staff's proposed adjustment in past proceedings?**

5 A. Yes. The Commission has approved this adjustment in numerous cases in the past. It has
6 been a standard uncontested adjustment in PSE and Puget Sound Power & Light
7 Company (PSE's predecessor Company) general rate cases over at least the last 25 years.
8 *See, e.g.,* Cause No. U-82-38, Third Supplemental Order, p. 25 (item 19 in the table of
9 uncontested adjustments to results of operations). As a more recent example, the
10 Commission's determination of revenue requirement for PacifiCorp in its 2006 general
11 rate case included an uncontested Customer Deposits Adjustment. *WUTC v. PacifiCorp*
12 *d/b/a Pacific Power & Light Company*, Dockets UE-061546 and UE-060817
13 (consolidated), Order 08, p. 59.

14
15 **Q. What is the impact of Staff's adjustment?**

16 A. The adjustment affects both electric and gas Washington jurisdictional results of
17 operations. In the electric results of operations, the adjustment reduces the Washington
18 electric rate base by \$1,903,185 and the Washington electric net operating income by
19 \$50,366, for a net decrease in revenue requirement of approximately \$206,000. In the
20 gas results of operations, the adjustment reduces the Washington gas rate base by
21 \$1,111,363 and the Washington gas net operating income by \$29,413, for a net decrease
22 in revenue requirement of approximately \$120,000.

1

2 **Q. Does this conclude your testimony?**

3 **A. Yes.**