Exhibit No. ___(EMA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-10_____________

DOCKET NO. UG-10_____________

DIRECT TESTIMONY OF

ELIZABETH M. ANDREWS

REPRESENTING AVISTA CORPORATION

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I. INTRODUCTION

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

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

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

A. I am a 1990 graduate of Eastern Washington University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. That same year, I passed the November Certified Public Accountant exam, earning my CPA License in August 1991[1]. I worked for Lemaster & Daniels, CPAs from 1990 to 1993, before joining the Company in August 1993. I served in various positions within the sections of the Finance Department, including General Ledger Accountant and Systems Support Analyst until 2000. In 2000, I was hired into the State and Federal Regulation Department as a Regulatory Analyst until my promotion to Manager of Revenue Requirements in early 2007. I have also attended several utility accounting, ratemaking and leadership courses.

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

A. As Manager of Revenue Requirements, aside from special projects, I am responsible for the preparation of normalized revenue requirement and pro forma studies for the various jurisdictions in which the Company provides utility services. During the last nine and

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

one-half years, I have assisted or led the Company's electric and/or natural gas general rate filings in Washington, Idaho and Oregon.

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

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

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

A. Yes. I am sponsoring Exhibit Nos.____(EMA-2) (Electric) and ___(EMA-3) (Natural Gas), which were prepared under my direction. These exhibits consist of worksheets, which show actual 2009 operating results (twelve-month period ending December 31, 2009), pro forma, and proposed electric and natural gas operating results and rate base for the State of Washington. The exhibits also show the calculation of the general revenue requirement, the derivation of the Company's overall proposed rate of return, the derivation of the net-operating-income-to-gross-revenue-conversion factor, and the specific pro forma adjustments proposed in this filing.

II. COMBINED REVENUE REQUIREMENT SUMMARY

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

A. Yes. After taking into account all standard Commission Basis adjustments, as well as additional pro forma and normalizing adjustments, the pro forma electric and natural gas rates of return ("ROR") for the Company's Washington jurisdictional operations are 5.14% and 5.68%, respectively. Both return levels are below the Company's requested rate of return of 8.33%. The incremental revenue requirement necessary to give the Company an opportunity to earn its requested ROR is $55,298,000 for the electric operations and $8,489,000 for the natural gas operations. The overall base electric increase associated with this request is 13.83%. The base natural gas increase is 5.38%.

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

A. The Company's currently authorized rate of return for its Washington operations is 8.25 %, effective January 1, 2010 for both our electric and natural gas systems.

III. ELECTRIC SECTION

Test Period for Ratemaking Purposes

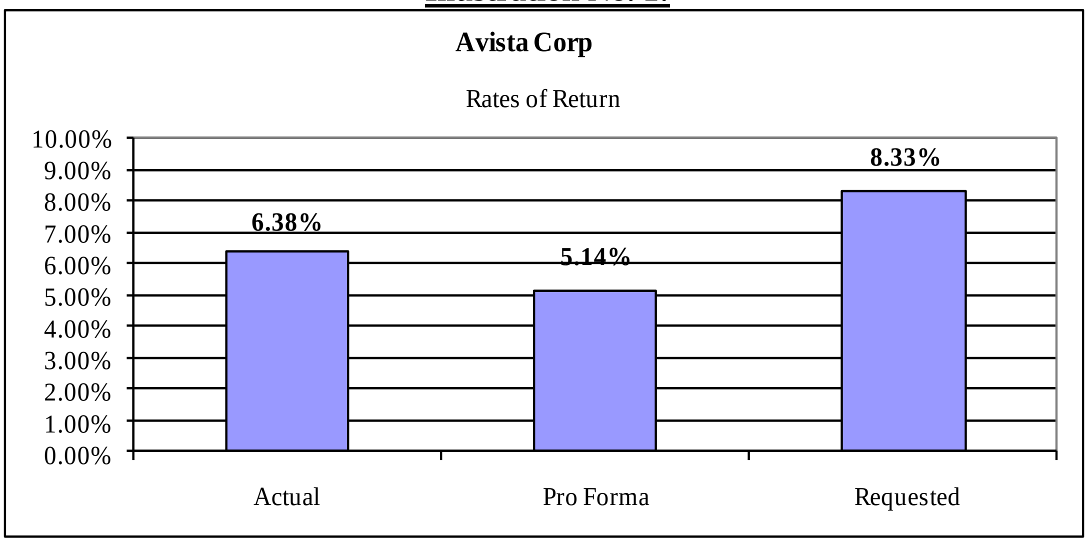
Q. On what test period is the Company basing its need for additional electric revenue?

A. The test period being used by the Company is the twelve-month period ending December 31, 2009, presented on a pro forma basis. Currently authorized rates were based upon the twelve months ending September 30, 2008 test year utilized in UE-090134, adjusted on a pro forma basis.

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

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

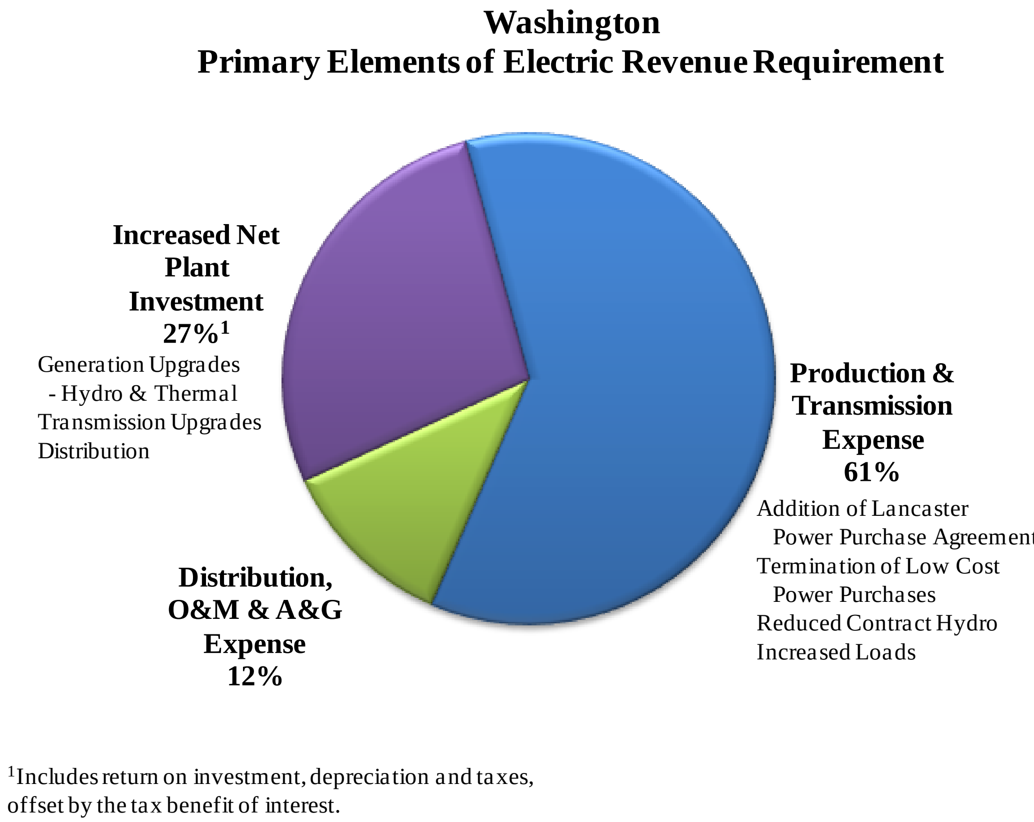
Illustration No. 1:



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

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

Illustration No. 2:



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

A. The first segment, representing the increases in Production and Transmission Expense, comprises approximately 61% of the overall request. The next largest segment is Increased Net Plant Investment. Net rate base for the Washington jurisdiction increased approximately $84.6 million, or 8.5%. The revenue requirement associated with the increase in Net Plant Investment represents approximately 27% of the overall Company request.

The remaining cost category, Distribution, O&M and A&G Expense, which includes increases to all other operating categories, such as distribution expenses, customer service, and administrative and general, totals approximately 12% of the overall request.

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

A. Yes. As discussed in Mr. Johnson's testimony, the level of Washington's share of power supply expense has increased by approximately $35.7 million ($55 million on a system basis) from the level currently in base rates.

The primary expense increases are the addition of the Lancaster plant, from which the Company began receiving power on January 1, 2010, and the expiration of four low-cost power supply contracts. The increase in pro forma net expense related to the inclusion of the Lancaster plant is approximately $18.9 million (system) or $12.3 million (Washington share). With regard to the power contracts, there are four low-cost 25 aMW power purchases that end December 31, 2010. The cost to replace these power purchase agreements increases expense by $15.8 million (system) or $10.2 million (Washington allocation). Mr. Johnson discusses each of the increased expenses in detail in his testimony.

In addition to the increased expenses covered by Mr. Johnson, the Company has also included a five-year amortization of the 2010 Lancaster deferred costs, estimated at $12.2 million. This adjustment, discussed later in my testimony, increases production amortization expense by $2.4 million.

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

A. Yes. A number of expense items have increased since the 2008 test year used in the last rate case. For example, net employee benefits such as wages, pension and medical insurance expenses have increased, as well as other administrative and general expenses such as those related to the Company's information services.

We are utilizing a 2009 test year, since that is the most recent normalized financial information the Company has available; however, new general electric rates resulting from this filing are not expected to go into effect until early 2011. Accordingly, the Company has included a number of pro forma adjustments to capture some of the measurable cost changes that the Company will experience from the test year. In particular, the Company pro formed in the increased costs associated with increasing information services net costs as described by Company witness Mr. Kensok ($2.4 million), and electric distribution vegetation management costs ($2.05 million) as discussed by Company witness Mr. Kinney. These two increased costs alone equate to approximately 43% of the distribution and other expense category shown in Illustration 2.

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

A. Looking at the changes to "gross" plant in service, Washington "gross" plant increased by approximately $166.1 million, as compared to what is currently included in rates. In order to meet the energy and reliability needs of our customers, $70.8 million of this increase is due to the Company's investment in thermal and hydro generating facilities, as well as additional transmission investment. Distribution "gross" plant increased $70.2 million above the current level included in rates, while general and intangible "gross" plant increased $25.1 million. After adjusting for accumulated depreciation and amortization, accumulated deferred income taxes, and the production property adjustment, the net increase to rate base from these items is $60.9 million. Lastly, the Company included a working capital adjustment in this case, which added $23.7 million to the Company's total adjusted rate base.

The specific pro forma capital expenditures undertaken by the Company to upgrade its generation, transmission and distribution facilities and improve operating efficiency and reliability, are discussed further by Mr. Storro regarding production assets, and Mr. Kinney regarding transmission and distribution assets. In addition to discussing the actual pro forma adjustment made regarding net plant investment, Mr. DeFelice also describes the general plant additions included in the Company's case.

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

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

Revenue Requirement

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

A. Yes. Exhibit No._____(EMA-2) shows actual and pro forma electric operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No.____(EMA-2) shows 2009 actual operating results and components of the average-of-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is pro forma results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn an 8.33% rate of return. Column (f) reflects pro forma electric operating results with the requested increase of $55,298,000. The restating adjustments shown in columns *(c)* through *(ah),* of pages 5 through 10 of Exhibit No._____(EMA-2), are consistent with current regulatory principles and the treatment reflected in the prior Commission Order in Docket No. UE-090134, with a few proposed changes by the Company as described in my testimony below.

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

A. Yes. Page 2 shows the calculation of the $55,298,000 revenue requirement at the requested 8.33% rate of return.

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

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital 8.33%. Company witness Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Company witness Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

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

A. Yes. Page 4 shows the derivation of the net-operating-income-to-gross-revenue-conversion factor. The conversion factor takes into account uncollectible accounts receivable, Commission fees and Washington State excise taxes. Federal income taxes are reflected at 35%.

Q. Now turning to pages 5 through 13 of your Exhibit No._____(EMA-2), would you please explain what those pages show?

A. Yes. Page 5 begins with actual operating results and rate base for the 2009 test period in column (b). Individual normalizing and restating adjustments that are standard components of our annual reporting to the Commission begin in column (c) on page 5 and continue through column (ah) on page 10. Individual pro forma adjustments begin in column (PF1) on page 11 and continue through column (PF13) on page 13. The final column on page 13 is the total pro forma operating results and rate base for the test period.

<u>Standard Commission Basis and Restating Adjustments</u>

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

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

The first adjustment, column (c) on page 5, entitled **Deferred FIT Rate Base**, reflects the rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery

System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing premiums, and contributions in aid of construction. These amounts are reflected on the average-of-monthly-average balance basis. The effect on Washington rate base is a reduction of $163,716,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for Washington's portion of the net of tax, unamortized gain on the sale of the Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period scheduled to end in 2011. This accounting treatment was approved in Order No. 01 in Docket No. U-071805. This adjustment reflects the average of monthly averages amount of the deferred gain for the 2011 rate period. The effect on Washington rate base is a reduction of $41,000.

The adjustment in column (e), **Colstrip 3 AFUDC Elimination**, is a reallocation of rate base and depreciation expense between jurisdictions. In Cause Nos. U-81-15 and U-82-10, the WUTC allowed the Company a return on a portion of Colstrip Unit 3 construction work in progress ("CWIP"). A much smaller amount of Colstrip Unit 3 CWIP was allowed in rate base in Case U-1008-144 by the Idaho Public Utilities Commission ("IPUC"). The Company eliminated the AFUDC associated with the portion of CWIP allowed in rate base in each jurisdiction. Since production facilities are allocated on the Production/Transmission formula, the allocation of AFUDC is reversed and a direct assignment is made. The rate base adjustment reflects the average-of-monthly-averages amount for the test period. The effect on Washington net operating income is an increase of $193,000. The effect of the reallocation on Washington rate base is a decrease of $1,700,000.

The adjustment in column (f), **Colstrip Common AFUDC**, is also associated with the Colstrip plants in Montana, and increases rate base. Differing amounts of Colstrip common facilities were excluded from rate base by this Commission and the IPUC until Colstrip Unit 4 was placed in service. The Company was allowed to accrue AFUDC on the Colstrip common facilities during the time that they were excluded from rate base. It is necessary to directly assign the AFUDC because of the differing amounts of common facilities excluded from rate base by this Commission and the IPUC. In September 1988, an entry was made to comply with a Federal Energy Regulatory Commission ("FERC") Audit Exception, which transferred Colstrip common AFUDC from the plant accounts to Account 186. These amounts reflect a direct assignment of rate base for the appropriate average-of-monthly-averages amounts of Colstrip common AFUDC to the Washington and Idaho jurisdictions. Amortization expense associated with the Colstrip common AFUDC is charged directly to the Washington and Idaho jurisdictions through Account 406 and is a component of the actual results of operations. The rate base adjustment reflects the average-of-monthly-averages amount for the test period. The effect on Washington rate base is an increase of $426,000.

The adjustment in column (g), **Kettle Falls Disallowance**, decreases rate base. The amounts reflect the Kettle Falls generating plant disallowance ordered by this Commission in Cause No. U-83-26. The disallowed investment and related depreciation, FIT expense, accumulated depreciation and accumulated deferred FIT are removed from actual results of operations. The rate base adjustment and the accumulated deferred FIT reflects the average-of-monthly-averages amount for the test period. The effect on Washington net operating income is a decrease of $56,000. The effect on Washington rate base is a decrease of $756,000.

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

A. Page 6 starts with the adjustment in column (h), **Customer Advances**, which decreases rate base for money advanced by customers for line extensions, as they will be recorded as contributions in aid of construction at some future time. The effect on Washington rate base is a decrease of $257,000.

The adjustment in column (i), **Customer Deposits**, deducts from electric rate base the average-of-monthly-averages of customer deposits held by the Company, as ordered by this Commission in Docket UE-090134. The corresponding interest paid on customer deposits is reclassified to utility operating expense, at the current WUTC interest rate of .33%. The effect on Washington rate base is a decrease of $3,060,000. The effect on Washington net operating income is a decrease of $6,000.

The adjustment in column (j), **Settlement Exchange Power,** reflects the rate base associated with the recovery of 64.1% of the Company's investment in Settlement Exchange Power. The 64.1% recovery level was approved by the Commission's second Supplemental Order in Cause No. U-86-99 dated February 24, 1987. Amortization expense and deferred FIT expense recorded during the test period are reflected in results of operations. The rate base adjustment and accumulated deferred FIT reflects the average-of-monthly-averages amount for the 2011 rate period. The effect on Washington rate base is an increase of $16,412,000.

The adjustment in column (k), **Restating CDA Settlement,** adjusts the 2009 test period AMA net asset and DFIT balances related to the 2008/2009 CDA Tribe Settlement payments

(Past Storage/§10(e)) and deferred costs to a 2011 AMA basis. In addition, this adjustment includes the 2011 AMA net asset and DFIT balance for the 2010 Past Storage/§10e settlement payment of $4 million. The expense portion of this adjustment includes the annual amortization of the net total asset ($41.6 million (system) of payments and deferred costs) and the annual $400,000 (system) future storage §10(e) payment.

The agreed upon settlement and payments included in this adjustment were approved by the Commission in the Company's 2008 electric general rate case proceeding, Docket No. UE-080416. As approved by the Commission's Order (See Order No. 08), in Docket No. UE-080416, the Company was allowed to defer the amortization of the settlement payments, which included the system payments of $25.0 million in December 2008, $10.0 million in 2009 and $4.0 million in 2010 for resolution of the past trespass and §10(e) charges, and the 2008 future §10(e) annual flat payment, with a carrying charge on the deferrals and unamortized balance, for future recovery. These deferred payments, including a return on the balance, are being amortized over the average remaining life of the Spokane River - Post Falls Project, or 45 years. The future §10(e) system payment schedule of $400,000 flat annual payments for the first 21 years of the new Spokane River license, starting in December 2008, and $700,000 flat annual payments for the remaining years of the license, was also approved.

During 2009, 100% of Washington's share of the amortization of the assets associated with the 2008/2009 past storage and §10(e) charges were deferred for future recovery (see adjustment (l) – "Restating CDA Settlement Deferral" below). The effect on Washington rate base is an increase of $4,676,000 above that in the test period. The effect on Washington net operating income is a decrease of $558,000.

The adjustment in column (l), **Restating CDA Settlement Deferral,** adjusts the 2009 net assets associated with the 2008/2009 past storage and §10(e) charges deferred for future recovery to a 2011 AMA basis, and records the annual amortization expense based on a three-year amortization. As noted above in adjustment (k) "Restating CDA Settlement," the Company was allowed to defer the amortization of the settlement payments ($35.8 million of 2008/2009 system total payments), with a carrying charge on the deferrals and unamortized balance, for future recovery. These deferred payments, including a return on the balance, are being amortized over 45 years. Washington's share of the 2009 deferred amortization, plus interest totaled approximately $1.55 million. The Company has proposed a three-year amortization for recovery of this amount, resulting in approximately $506,000 of annual expense (rather than $35,000 annually over the remaining 44-year life). The effect on Washington rate base is an increase of $822,000. The effect on Washington net operating income is a decrease of $329,000.

The adjustment in column (m), **Restating CDA/SRR (Spokane River Relicensing) CDR,** adjusts the 2009 net assets associated with the CDA Tribe settlement 4(e) Spokane River relicensing conditions, deferred for future recovery, to a 2011 AMA basis. The expense portion of this adjustment includes the annual amortization of the net total asset ($12 million (system) of payments and deferred costs); amortization of the deferred balance over a three year period; and the annual $2 million (system) of CDR payment expense.

As noted below in adjustment (n) "Restating Spokane River Relicensing," costs associated with the CDA Tribe settlement 4(e) relicensing conditions, with a carrying charge on the deferrals and unamortized balance, were deferred for future recovery. These deferred payments, including a return on the balance, were originally planned to be amortized over the life of the license, or 50 years. Washington's share of the 2009 deferred amortization, plus interest totaled approximately $112,700. The Company has included a three-year amortization for recovery of this amount, resulting in approximately $36,000 of annual expense (rather than $2,300 annually over the remaining 50-year life). The effect on Washington rate base is an increase of $3,746,000. The effect on Washington net operating income is a decrease of $951,000.

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

A. Page 7 starts with the adjustment in column (n), **Restating Spokane River Relicensing**, which adjusts the 2009 AMA test period net asset and DFIT balances related to the Spokane River relicensing costs to a 2011 AMA basis, and records the annual amortization expense based on a 50-year amortization. In June 2009, Avista received its 50 year FERC-issued license for the Spokane River Project, at which time the costs of these efforts were transferred to intangible plant. Costs associated with this effort included actual life-to-date expenditures from April 2001 through June 30, 2009. The total of these costs were reviewed and approved over the Company's two previous general electric rate case proceedings, Docket Nos. UE-080416 and UE-090134. The Company was allowed to defer the amortization of the licensing costs, costs associated with the CDA Tribe settlement 4(e) relicensing conditions and the associated Program, Enhancement & Mitigation (PM&E) charges, including a carrying charge on these amounts, until rates went into effect January 1, 2010. These deferred payments, including a return on the balance, were originally planned to be amortized over the life of the license, or 50 years. During 2009, Washington's share of the amortization of the assets associated with the licensing costs and 4(e) payments for the period June through December were deferred for future recovery (see adjustment o – "Restating Spokane River Deferral" and adjustment m – "Restating CDA/SRR CDR Fund"). The Company also spent approximately $725,400 on PM&E costs in 2009; deferring 100% of Washington's share, including interest, for future recovery (see adjustment p – "Restating Spokane River PM&E Deferral"). The effect on Washington rate base is an increase of $7,271,000 above that in the test period. The effect on Washington net operating income is a decrease of $242,000.

The adjustment in column (o), **Restating Spokane River Deferral,** adjusts the 2009 net asset and DFIT balances related to the Spokane River deferred relicensing costs to a 2011 AMA basis, and records the annual amortization expense based on a three-year amortization. As noted above in adjustment (n) "Restating Spokane River Relicensing," the Company was allowed to defer the amortization of the licensing costs and costs associated with the CDA Tribe settlement 4(e) relicensing conditions, including a carrying charge on these amounts, for future recovery. Washington's share of the 2009 deferred amortization, plus interest for the period July though December totaled approximately $743,200. These deferred payments, including a return on the balance, were originally planned to be amortized over the life of the license, or 50 years. However, the Company has included a three-year amortization for recovery of this amount, resulting in approximately $243,000 of annual expense (rather than $15,000 annually over the remaining 50-year life). The effect on Washington rate base is an increase of $395,000. The effect on Washington net operating income is a decrease of $158,000.

The adjustment in column (p), **Restating Spokane River PM&E Deferral,** adjusts the 2009 net asset and DFIT balances related to the Spokane River deferred PM&E costs to a 2011 AMA basis, and records the annual amortization expense based on a three-year amortization. As noted above in adjustment (n) "Restating Spokane River Relicensing," the Company was allowed to defer the Spokane River deferred PM&E charges, including a carrying charge on these amounts, for future recovery. Washington's share of the 2009 deferred PM&E costs, plus interest, totaled approximately $471,900. The Company has included a three-year amortization for recovery of this amount, resulting in approximately $154,000 of annual expense. The effect on Washington rate base is an increase of $250,000. The effect on Washington net operating income is a decrease of $100,000.

Included within my workpapers provided with the Company's filing is the detail for each of the adjustments (k) through (p) described above.

The adjustment in column (q), **Restating Montana Riverbed Lease**, includes the costs associated with the Montana Riverbed lease settlement. In this settlement, the Company agreed to pay the State of Montana $4.0 million annually beginning in 2007, with annual inflation adjustments, for a 10-year period for leasing the riverbed under the Noxon Rapids Project and the Montana portion of the Cabinet Gorge Project. The first two annual payments were deferred by Avista as approved in Docket No. UE-072131. In Docket No. UE-080416 (see Order No. 08), the Commission approved the Company's accounting treatment of the deferred payments, including accrued interest, to be amortized over the remaining eight years of the agreement starting on January 1, 2009. This restating adjustment includes one-eighth of the deferred balance amortization and the increase in the annual lease payment expense for the additional annual inflation. This adjustment decreases Washington net operating income by $53,000 and increases rate base by $2,419,000.

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

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

A. Page 8 starts with the adjustment in column (r), **Eliminate B & O Taxes**, that eliminates the revenues and expenses associated with local business and occupation (B & O) taxes, which the Company passes through to its Washington customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $36,000.

The adjustment in column (s), **Property Tax**, restates the test period accrued levels of property taxes to the most current information available and eliminates any adjustments related to the prior year. This adjustment also annualizes the increase in property taxes effective July 1, 2009, related to the Company's Coyote Springs plant located in Oregon. Prior to July 1, 2009, the Company had been exempted from this property tax assessment for five years under a tax abatement as a result of the plant being located in the Columbia River Enterprise Zone in Oregon. The effect of this adjustment decreases Washington net operating income by $1,194,000.

The adjustment in column (t), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to increase Washington net operating income by $42,000.

The adjustment in column (u), **Regulatory Expense**, restates recorded 2009 regulatory expense to reflect the WUTC assessment rates applied to revenues for the test period and the actual levels of FERC fees paid during the test period. The effect of this adjustment is to decrease Washington net operating income by $47,000.

The adjustment in column (v), **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to increase Washington net operating income by $35,000.

The adjustment in column (w), **FIT**, adjusts the FIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items, matching the jurisdictional allocation of other Schedule M items to related Results of Operations allocations and adjusts the appropriate level of production tax credits and income tax credits on qualified generation. The net FIT and production tax credit adjustments decrease Washington net operating income by $945,000. Adjusting for the proper level of deferred tax expense for the test period increases Washington net operating income by $26,000. This adjustment also reflects the proper level of amortized income tax credit for the test period increasing Washington net operating income by an additional $29,000. Therefore, the net effect of this adjustment, all based upon a Federal tax rate of 35%, is to decrease Washington net operating income by $890,000.

The adjustment in column (x), **Eliminate WA ERM Surcharge & Deferrals**, removes the effects of the financial accounting for the Energy Recovery Mechanism (ERM.) The ERM normalizes and defers certain net power supply and transmission revenues and costs pursuant to the commission approved deferral and recovery mechanism. The adjustment removes the ERM surcharge revenue as well as the deferral and amortization amounts and certain directly assigned power costs and net transmission costs associated with the ERM. The effect of this adjustment is to increase Washington net operating income by $153,000.

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

A. Page 9 starts with the adjustment in column (y), **Nez Perce Settlement Adjustment**, which reflects an increase in production operating expenses. An agreement was entered into between the Company and the Nez Perce Tribe to settle certain issues regarding earlier owned and operated hydroelectric generating facilities of the Company. This adjustment directly assigns the Nez Perce Settlement expenses to the Washington and Idaho jurisdictions. This is necessary due to differing regulatory treatment in Idaho Case No. WWP-E-98-11 and Washington Docket No. UE-991606. This restating adjustment is consistent with Docket No. UE-011595. The effect of this adjustment is to decrease Washington net operating income by $7,000.

The adjustment in column (z), **Eliminate A/R Expenses**, removes expenses associated with the sale of customer accounts receivable. The effect of this adjustment is to increase Washington net operating income by $181,000.

The adjustment in column (aa), **Office Space Charged to Subsidiaries**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T and is consistent with our last general rate case in Docket No. UE-090134. The effect of this adjustment is to increase Washington net operating income by $5,000.

The adjustment in column (ab), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to increase Washington net operating income by $7,000.

The adjustment in column (ac), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 2000 and 2009. This restating adjustment is made as a result of the Commission's Order in Docket No. UE-050842 and is consistent with Docket No. UE-090134. The effect of this adjustment is to increase Washington net operating income by $53,000.

The adjustment in column (ad), **Revenue Normalization**, is an adjustment taking into account known and measurable changes that include revenue repricing (including the current authorized rates approved in Docket No. UE-090134), weather normalization and a recalculation of unbilled revenue. Revenues associated with the Schedule 91 Tariff Rider and Schedule 59 Residential Exchange are excluded from pro forma revenues, and the related amortization expense is eliminated as well. Company witness Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $3,882,000.

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

A. Page 10 starts with the adjustment in column (ae), **Miscellaneous Restating Adjustments**, which removes a number of non-operating or non-utility expenses associated with advertising, dues and donations included in error in the test period actual results. The Company also removes 50% of director meeting expenses, as ordered in Docket No. UE-090134, and 10% of director fees expenses. The effect of this adjustment is to increase Washington net operating income by $161,000.

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

A. Since the last rate case, the Company has conducted additional research regarding the average estimated time spent by Avista's Directors on utility versus non-utility activities. Each Director was contacted to determine, based on their actual experience, the estimated time spent on utility versus non-utility duties and responsibilities. The responses from the Directors indicated that approximately 90% of the Directors' time is dedicated to utility matters, and approximately 10% to non-utility.

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

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

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

Directors' fees are the Directors' compensation package offered to attract and retain qualified directors. Based on the actual time dedicated to the utility, a 90/10 sharing should be applied to Directors' fees. Using a 90/10 sharing for director fees reduced the Company's expense included in this filing by approximately $49,000.

Q. Please continue describing the adjustments on page 10.

A. The adjustment in column (af), **Colstrip Mercury Emission O&M**, includes Washington's share of the annual O&M expense of approximately $.9 million ($1.4 million system) associated with the mercury control project at Colstrip planned during the 2011 rate year. In Docket No. UE-090134 the Commission reviewed and approved the 2010 level of Colstrip mercury emission O&M expense of $1.5 million (system). This adjustment decreases Washington net operating income by $577,000.

The adjustment in column (ag), **Working Capital**, increases total rate base for the Company's working capital adjustment. The Company has calculated cash working capital in this proceeding on the basis of the "1/8 of O&M" formula (also known as the Federal Energy Regulatory Commission's "one-eighth" formula or "45 day" method). This methodology divides Washington total O&M expenses (less fuel: accounts 501 and 547; and purchased power expenses: account 555) by eight, the approximate number of 45 day periods within a year. FERC's use of 45 days represents an estimate of days that elapse between payments for operating expenses associated with providing service to customers and receiving payment from customers. Since investors supply the funds to finance operations during this lag period, it is appropriated to provide a return on those working capital funds. The Company believes that this methodology, given the complexities of a multi-state, multi-service utility such as Avista is a reasonable approach for calculating an individual state and service working capital adjustment. The effect on Washington rate base is an increase of $23,695,000.

The adjustment in column (ah), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies. As applied to Washington's pro forma level of rate base, this produces a pro forma level of tax deductible interest expense. The Federal income tax effect of the restated level of interest for the test period decreases Washington net operating income by $962,000.

The last column on page 10, entitled **Restated Total**, subtotals all the preceding columns (b) through column (ah), excluding the subtotal column. These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports, except power supply[2].

<u>Pro Forma Adjustments</u>

Q. Please explain the significance of the 13 columns beginning at page 11 on your Exhibit No.____(EMA-2).

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[2] The restated total also includes an increase in expense necessary to annualize certain 2009 expenses included in the test period, (i.e. Colstrip mercury emission expense, Montana riverbed lease, Spokane River and CDA Tribe Settlement expense.)

A. The adjustments starting on page 11 are pro forma adjustments that recognize the jurisdictional impacts of items that will impact the pro forma operating period for known and measurable changes. They encompass revenue and expense items as well as additional capital projects. These adjustments bring the operating results and rate base to the final pro forma level for the test year.

Q. Please continue with your explanation of the adjustments starting on page 11.

A. The adjustment in column (PF1), **Pro Forma Power Supply**, was made under the direction of Mr. Johnson and is explained in detail in his testimony. This adjustment includes pro forma power supply related revenue and expenses to reflect the twelve-month period January 1, 2011 through December 31, 2011. Mr. Johnson's testimony outlines the system level of pro forma power supply details that are included in this adjustment. This adjustment calculates the Washington jurisdictional share of those figures, and also eliminates an offsetting direct assignment of certain power supply costs included in the base Results of Operations. The net effect of the power supply adjustments decreases Washington net operating income by $18,288,000.

The adjustment in column (PF2), **Pro Forma Production Property Adjustment,** adjusts total production and transmission revenues, expenses, and rate base by a factor that reflects the percentage increase of the 2011 pro forma period Washington retail load, above the 2009 Washington test year retail load. The adjustment is made to avoid the over-recovery of production and transmission costs, since the revenue requirement associated with those costs is being spread to test year retail load. The use of a production property adjustment, in conjunction with pro forma rate year loads for power supply, results in a better matching of revenues and expenses during the period that new retail rates from the case will be in effect. This adjustment is consistent with the methodology approved in Docket No. UE-090134. The effect of this adjustment on Washington net operating income is an increase of $8,798,000. The effect on Washington total rate base is a decrease of $37,643,000.

The adjustment in column (PF3), **Pro Forma Lancaster Amortization,** includes the amortization of the 2010 net deferred Lancaster plant Power Purchase Agreement (PPA) expenses estimated at $12.3 million. In docket No. UE-090134 (See Order No. 10), the WUTC authorized the Company to defer the 2010 expenses for a period not to exceed twenty-four months from the beginning of the Lancaster contract (January 1, 2010), provided that the Company files for the recovery of the Lancaster contract costs in a general rate case. Deferral ends on the effective date of the final decision by the Commission in that proceeding. The Company was also authorized to accrue a carrying charge on the deferral balance at the same rate applied to its ERM deferral balance (i.e. cost of debt). The estimated (Washington share) of the net expense to be deferred prior to any carrying costs is anticipated to be approximately $12.3 million (See Docket No. 100080[3]). For purposes of this filing, recognizing that the deferral amount may be different than originally estimated, the Company used the $12.3 million for determining the annual expense, and used a five-year amortization period. The Company also proposes rate base treatment of the unamortized balance during this five year period until fully amortized in 2015. At the conclusion of this rate proceeding, a true-up will be necessary to determine the actual Lancaster net expense, amortization and rate base amounts, based on the

[3] See Docket No. 100080, regarding Avista petition to the WUTC requesting an accounting order for the deferral of the Lancaster Generating Facility (Lancaster) costs beginning in January 2010.

actual deferral balance at that time. The effect of this adjustment on Washington net operating income is a decrease of $1,583,000. The effect on Washington rate base is an increase of $7,127,000.

The adjustment in column (PF4), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in adjustment PF5. For non-union employees, test period wages and salaries are restated to include the March 2010 overall actual increase of 2.8%, and 10 months of the planned March 2011 increase of 2.4%. Company witness Ms. Feltes discusses the Company's overall compensation plan and notes that the Company's Board is scheduled to address the 2011 planned increase at the Board of Director's meeting in May 2010.

Also included in this adjustment are the 2010 and 2011 union contract increases currently being negotiated. The Company anticipates a final union contract agreement will be completed by the end of second quarter of 2010. The methodology behind this adjustment is consistent with Docket No. UE-090134. The effect of this adjustment on Washington net operating income is a decrease of $1,269,000.

The adjustment in column (PF5), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating executive compensation test period salary expense to actual salary levels at 2010. This adjustment takes into account changes in compensation for the executive team in 2010 only. Although the officers did not receive a 2009 pay increase, this adjustment does reflect an annual increase for the actual overall 2010 officer increase of 2.86%. Compensation costs for non-utility operations are excluded, as executives routinely charge a portion of their time to non-utility operations, commensurate with the amount of time spent on such activities, based on a survey of each executive. The methodology behind this adjustment is consistent with what was approved in Docket No. UE-090134. The impact of this adjustment on Washington net operating income is a decrease of $102,000.

Q. Please now turn to page 12 and continue with your explanation of the adjustments included on that page.

A. Column (PF6), **Pro Forma Transmission Rev/Exp,** was made under the direction of Mr. Kinney and is explained in detail in his testimony. This adjustment includes pro forma transmission-related revenues and expenses to reflect the twelve-month period January 1, 2011 through December 31, 2011. As described by Mr. Kinney, this adjustment includes, among other things, the increase in revenue as a result of the recently-concluded FERC transmission rate case. The net effect of the transmission revenue and expense adjustments increases Washington net operating income by $1,167,000.

The adjustment in column (PF7), **Pro Forma Capital Additions 2010**, pro forms in certain capital cost and expenses associated with capital expenditures for 2010. This adjustment includes projects expected to be completed and transferred to plant-in-service by December 31, 2010. The capital costs have been included for the pro forma period that includes the associated depreciation expense and property tax. The rate base associated with these capital costs, net of accumulated depreciation and deferred income tax, have been stated on a 2011 average-of-monthly-average basis. This adjustment was made under the direction of Mr. DeFelice and is described further in his testimony. As also described in Mr. DeFelice's testimony, any known offsets to individual projects have been applied to the individual projects as appropriate and included within this adjustment as an O&M reduction. The Production Property Adjustment is also applied to the production and transmission components of these additions as discussed above. This adjustment decreases Washington net operating income by $1,067,000 and increases rate base by $55,984,000.

The adjustment in column (PF8), **Pro Forma Noxon Generation 2010/2011,** pro forms in the Noxon capital projects planned for completion in April 2010 and April 2011. As explained further by Mr. Storro, Noxon Unit #3 is scheduled to have a new turbine and complete mechanical overhaul between August 2009 and April 2010. These unit upgrades are planned to increase unit efficiency and boost unit ratings. The additional generation from the Noxon Unit #2 completion planned for April of 2011 has also been included in the Aurora Dispatch Model for the rate year, as discussed by Company witness Mr. Kalich. Including the additional generation from this Noxon upgrade in the Dispatch Model, ultimately reducing power supply expenses for customers in the 2011 rate year, and including this project in rate base for the rate period provides a proper match in revenues with expenses for this project. The Noxon Unit #2 project was included in rate base and within the Aurora model at 75% of the cost and generation (equivalent to 9 months due to an April 1, 2011 effective date). This adjustment decreases Washington net operating income by $191,000 and increases rate base by $8,656,000.

The adjustment in column (PF9), **Pro Forma Vegetation Management**, pro forms in the distribution O&M expense associated with the Vegetation Management Program as described further by Mr. Kinney. This adjustment decreases Washington net operating income by $1,332,000.

The adjustment in column (PF10), **Pro Forma Information Services**, pro forms in the administrative and general (A&G) expenses associated with incremental changes for information services costs planned for 2010 and 2011 above test period levels. As explained by Mr. Kensok, these incremental costs include increases in expenses for supporting applications utilized by the Company, additional required security and compliance requirements, and additional dollars required for hosting fees, application fees, software maintenance and license fees. Included in Exhibit No. __(JMK-2) is documentation supporting these changes. This adjustment decreases Washington net operating income by $1,555,000.

Q. Please turn to page 13 and explain the adjustments shown there.

A. The adjustment in column (PF11), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense and increases Washington net operating income by $417,000.

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

A. The Company's pension expense portion of this adjustment is determined in accordance with Financial Accounting Standard 87 ("FAS-87"), and has decreased on a system basis from $24.2 million for the actual test year costs for the twelve months ended December 31, 2009, to $19.7 million for 2010. At this time the amounts included in this case are estimated with the most current available data. Preliminary Pension expense is determined by an outside actuarial firm, in accordance with FAS-87, and provided to the Company late in the first quarter of each year. These calculations and assumptions are reviewed by the Company's outside accounting firm annually for reasonableness and comparability to other companies. Due to the timing of this report, additional information may become known during the course of these proceedings that may require a modification to this adjustment.

The decrease in pension expense is due primarily to the investment performance of plan assets during the past year. In addition, the Pension Protection Act (PPA) of 2006 requires companies to annually increase the funding level of their pension plans in order to eventually achieve a fully-funded plan, which also impacts the plan asset balance and level of expense.

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

A. The Company's medical insurance expense portion of this adjustment adjusts for the medical insurance costs planned for 2010 above the test period. Medical insurance expense has increased on a system basis from $16.9 million for the actual test year costs for the twelve months ended December 31, 2009, to $19.1 million for 2010. As discussed by Ms. Feltes, this increased cost is mainly due to increased large claims activity driven by various diagnostic categories such as cancer and heart disease, and an increase in the average age of our membership. Ms. Feltes also discusses the measures taken by the Company to mitigate the increases.

The net impact of the decrease in pension and the increase in medical costs is a net decrease in expense of $642,000.

Q. Please continue your explanation of the adjustment columns on page 13.

A. The adjustment in Column (PF12), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2010. Costs of system-wide insurance policies for 2010 were slightly above costs for policies in 2009, due to increased costs in general liability insurance. Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. In addition, Avista has removed a total of 10% of the total Directors' and Officers' insurance expense as ordered in Docket No. UE-09134. This adjustment decreases Washington net operating income by $42,000.

The adjustment in Column (PF13), **Pro Forma Clark Fork/Spokane River PM&E,** adjusts the level of expense included in the test period for the Clark Fork and Spokane River Protection, Mitigation, and Enhancement (PM&E) expenses, to the Company's planned expenditures for 2010 required by the Company's licensing of those dams. Mr. Storro discusses the additional level of planned PM&E expenditures further. The effect of this adjustment is to decrease Washington net operating income by $1,619,000.

The last column, Pro Forma Total, reflects total pro forma results of operations and rate base consisting of test period actual results (twelve-months ending December 31, 2009) and the total of all adjustments.

Q. Referring back to page 1, line 43, of Exhibit No._____(EMA-2), what was the actual and pro forma electric rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 6.38%. The pro forma rate of return is 5.14% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.33% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington electric operations to allow the Company an opportunity to earn its proposed 8.33% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $34,349,000, as shown on line 5, page 2 of Exhibit No._____(EMA-2). The resulting revenue requirement is shown on line 7 and amounts to $55,298,000, or an increase of 13.83% over pro forma general business revenues.

IV. NATURAL GAS SECTION

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

A. The test period being used by the Company is the twelve-month period ending December 31, 2009, presented on a pro forma basis.

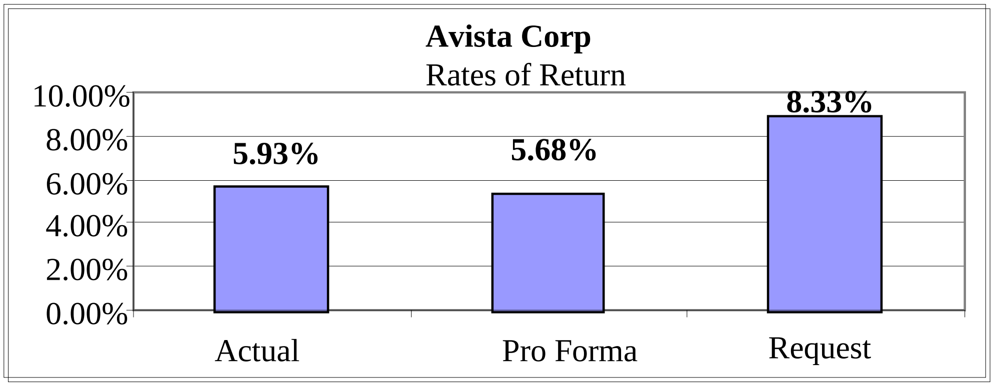
Q. When was the last change to base rates in the Washington jurisdiction?

A. The last change to base gas rates in Washington occurred on January 1, 2010 as a result of the Order received in Docket No. UG-090135.

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

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

Illustration No. 3:



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

A. The Company's natural gas request is driven by changes in various operating cost components, mainly distribution operation and maintenance and administrative and general expenditures. In addition, over 22% of the overall increase in requested revenue requirement is due to the transfer of a portion of the Jackson Prairie storage facility from Avista Energy to Avista Utilities on May 1, 2011. Company witness Mr. Christie discusses the details of this project, and the plans to move it to the Utility.

The total of the increased operating cost components requested in this case causes an increase in the fixed costs of providing gas service to customers. I describe the pro forma adjustments included in this case later in my testimony.

Revenue Requirement

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

A. Yes. Exhibit No._____(EMA-3) shows actual and pro forma gas operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No._____(EMA-3) shows 2009 operating results (twelve-months ended December 31, 2009) and components of the average-of-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is pro forma results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn a 8.33% rate of return. Column (f) reflects pro forma gas operating results with the requested increase of $8,489,000.

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

A. Yes. Page 2 shows the calculation of the $8,489,000 revenue requirement at the requested 8.33% rate of return.

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

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital calculation of 8.33%. Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

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

A. Yes. Page 4 shows the derivation of the net-operating-income-to-gross-revenue conversion factor. The conversion factor takes into account uncollectible accounts receivable, Commission fees and Washington State excise taxes. Federal income taxes are reflected at 35%.

Q. Now turning to pages 5 through 9 of your Exhibit No._____(EMA-3), would you please explain what those pages show?

A. Yes. Page 5 begins with actual operating results and rate base for the test period in column (b). Individual normalizing adjustments that are standard components of our annual reporting to the Commission begin in column (c) on page 5 and continue through column (v) on page 8. Individual pro forma adjustments begin in column (PF1) on page 9 and continue through column (PF7) on page 9. The final column on page 9 is the total pro forma operating results and rate base for the test period.

Standard Commission Basis Adjustments

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

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

The first adjustment, column (c) on page 5, entitled **Deferred FIT Rate Base**, reflects the rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing premiums, and contributions in aid of construction. These amounts are reflected on the average of monthly average balance basis. The effect on Washington rate base is a reduction of $31,005,000.

The adjustment in column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for Washington's portion of the net of tax, unamortized gain on the sale of the

Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period scheduled to end in 2011. This accounting treatment was approved in Order No. 01 in Docket No. U-071805. This adjustment reflects the average-of-monthly-averages amount of the deferred gain for the 2011 rate period. The effect on Washington rate base is a reduction of $14,000.

The adjustment in column (e), **Gas Inventory**, reflects the adjustment to rate base for the average-of-monthly-average value of gas stored at the Company's Jackson Prairie underground storage facility through the test period. The effect on Washington rate base is an increase of $8,440,000.

The adjustment in column (f), entitled **Customer Advances**, decreases rate base for funds advanced by customers for line extensions, as they are generally recorded as contributions in aid of construction at some future time. The effect of this adjustment on Washington rate base is a decrease of $38,000.

The adjustment in column (g), entitled **Customer Deposits,** deducts from natural gas rate base the average-of-monthly averages of customer deposits held by the Company, as ordered by this Commission in Docket UG-090135. The corresponding interest paid on customer deposits is reclassified to an operating expense, at the current WUTC interest rate of .33%. The effect on Washington rate base is a decrease of $1,359,000. The effect on Washington net operating income is a decrease of $3,000.

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

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

A. The first adjustment on page 6 in column (h), entitled **Revenue Normalization & Gas Cost Adjustment**, is an adjustment taking into account known and measurable changes that include revenue normalization (including the current authorized rates approved in Docket No. UG-090135), which reprices customer usage under presently effective rates, as well as weather normalization and an unbilled revenue calculation. Associated gas costs are replaced with gas costs computed using normalized volumes at the currently effective "weighted average cost of gas," or WACOG rates. Revenues associated with the temporary Gas Rate Adjustment Schedule 155 and Schedule 191 Tariff Rider are excluded from pro forma revenues and the related amortization expense is eliminated as well. Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to decrease Washington net operating income by $395,000.

The adjustment in column (i), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated with local business and occupation taxes, which the Company passes through to customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O Taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $6,000.

The adjustment in column (j), **Property Tax**, restates the test period accrued levels of property taxes to the most current information available and eliminates any adjustments related to the prior year. The effect of this particular adjustment is to decrease Washington net operating income by $124,000.

The adjustment in column (k), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to increase Washington net operating income by $229,000.

The adjustment in column (l), entitled **Regulatory Expense Adjustment**, restates recorded 2009 regulatory expense to reflect the WUTC assessment rates applied to revenues for the test period. The effect of this adjustment is to increase Washington net operating income by $24,000.

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

A. The first adjustment on page 6 in column (m), entitled **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to increase Washington net operating income by $123,000.

The adjustment in column (n), entitled **FIT**, adjusts the FIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items and matches the jurisdictional allocation of other Schedule M items to related Results of Operations allocations. This adjustment also reflects the proper level of deferred tax expense for the test period. The effect of this adjustment, all based upon a Federal tax rate of 35%, is to decrease Washington net operating income by $7,000.

The adjustment in column (o), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 2000 and 2009. This restating adjustment is made as a result of the Commission's Order in Docket No. UG-050843 and consistent with UG-090135. The effect of this adjustment is to increase Washington net operating income by $3,000.

The adjustment in column (p), **Eliminate A/R Expenses**, removes expenses associated with the sale of customer accounts receivable. The effect of this adjustment is to increase Washington net operating income by $32,000.

The adjustment in column (q), **Office Space Charges to Subs**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T and is consistent with our last general rate case in Docket No. UG-090135. The effect of this adjustment is to increase Washington net operating income by $1,000.

The adjustment in column (r), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to increase Washington net operating income by $1,000.

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

A The first adjustment on page 8, column (s), **Weatherization & DSM Investment Amortization Removal,** removes the amortization expense included in the test period due to the completion of the weatherization and DSM investment rate base being fully amortized in 2009. The effect of this adjustment is to increase Washington net operating income by $200,000.

The adjustment in column (t), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising and dues and donations included in error in the test period actual results. The Company also removes 50% director meeting expenses, as ordered in Docket No. UE-090135, and 10% of director fees expenses. (See additional information provided in the electric summary section above.) The effect of this adjustment is to increase Washington net operating income by $48,000.

The adjustment in column (u) **Working Capital**, increases total rate base for the Company's working capital adjustment. The Company has calculated cash working capital in this proceeding on the basis of the "1/8 of O&M" formula (also known as the Federal Energy Regulatory Commission's "one-eighth" formula or "45 day" method). This methodology divides Washington total O&M expenses (less purchased gas: accounts 804, 805, and 808) by eight, the approximate number of 45 day periods within a year. FERC's use of 45 days represents an estimate of days that elapse between payments for operating expenses associated with providing service to customers and receiving payment from customers. Since investors supply the funds to finance operations during this lag period, it is appropriated to provide a return on those working capital funds. The Company believes that this methodology, given the complexities of a multi-state, multi-service utility such as Avista is a reasonable approach for calculating an individual state and service working capital adjustment. The effect on Washington rate base is an increase of $4,053,000.

The adjustment in column (v), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies. As applied to Washington's pro forma level of rate base, it produces a pro forma level of tax deductible interest expense. The federal income tax effect of the restated level of interest for the test period decreases Washington net operating income by $111,000.

The next column on page 8, entitled **Restated Total**, subtotals all the preceding columns (b) through column (v), excluding the subtotal column. These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports.

Pro Forma Adjustments

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

A. The adjustments starting on page 9 are pro forma adjustments to reflect known and measurable changes between the test period and the pro forma period. In this case, they encompass revenue and expense items, and natural gas capital projects. These adjustments bring the operating results and rate base to the final pro forma level for the test year.

Q. Please provide an explanation of the adjustments shown on page 9.

A. The adjustment in column (PF1), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in adjustment PF2. For non-union employees, test period wages and salaries are restated to include the March 2010 overall actual increase of 2.8%, and 10 months of the planned March 2011 increase of 2.4%. Ms. Feltes discusses the Company's overall compensation plan and notes that the Company's Board is scheduled to address the 2011 planned increase at the Board of Director's meeting in May 2010.

Also included in this adjustment are the 2010 and 2011 union contract increases currently being negotiated. The Company anticipates a final union contract agreement will be completed by the end of second quarter of 2010. The methodology behind this adjustment is consistent with Docket No. UG-090135. The effect of this adjustment on Washington net operating income is a decrease of $367,000.

The adjustment in column (PF2), **Pro Forma Labor-Executive**, reflects known and measurable changes to executive compensation, restating executive compensation test period salary expense to actual salary levels at 2010. This adjustment takes into account changes in compensation for the executive team in 2010 only. Although the officers did not receive a 2009 pay increase, this adjustment does reflect an annual increase for the actual overall 2010 officer increase of 2.86%. Compensation costs for non-utility operations are excluded, as executives routinely charge a portion of their time to non-utility operations, commensurate with the amount of time spent on such activities, based on survey of each executive. The methodology behind this adjustment is consistent with what was approved in Docket No. UG-090135. The impact of this adjustment on Washington net operating income is a decrease of $29,000.

The adjustment in column (PF3), **Pro Forma Capital Additions 2010**, pro forms in capital cost and expenses associated with general plant projects expected to be completed and transferred to plant-in-service by December 31, 2010. The capital costs have been included for the pro forma period, as well as the associated depreciation expense and property tax. The rate base associated with these capital costs, net of accumulated depreciation and deferred income tax, have been stated on a 2011 average-of-monthly-average basis. This adjustment was made under the direction of Mr. DeFelice and is described further in his testimony. As also described in Mr. DeFelice's testimony, any known offsets to individual projects have been applied to the individual projects as appropriate and included within this adjustment as an O&M reduction. This adjustment decreases Washington net operating income by $23,000 and increases rate base by $1,525,000.

The adjustment in column (PF4), **Pro Forma JP Storage**, pro forms revenues, expenses, capital investment and inventory for the increased storage capacity and deliverability associated with the transfer on May 1, 2011 of a portion of the Jackson Prairie (JP) Storage facility to the Utility that was previously utilized by Avista Energy. Assets with a net book value of approximately $11.6 million will transfer from Avista Energy to Avista Utilities, which is comprised of approximately $5.9 million of cushion gas and approximately $5.7 million of fixed assets. Mr. Christie discusses the details of this transfer.

Washington's share of these assets on a 2011 average-of-monthly-average basis increases net rate base by $4,1065,000. The adjustment also includes a rate base increase of $8,714,000 for the working gas associated with the additional storage. In addition, underground storage expense increased for the additional operating, depreciation and property taxes expense by approximately $155,000. The details of the proposed accounting treatment of this adjustment is provided with my workpapers. The impact of this adjustment decreases Washington net operating income by $101,000 and increases rate base by $12,820,000.

The adjustment in column (PF5), **Pro Forma Information Services**, pro forms in the administrative and general (A&G) expenses associated with incremental changes for information services costs planned for 2010 and 2011 above the test period levels (as explained in the Electric Section above). The impact of this adjustment on Washington net operating income is a decrease of $430,000.

The adjustment in column (PF6), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense (as explained in the Electric Section above) and increases Washington net operating income by $120,000.

The adjustment in Column (PF7), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2010. Costs of system-wide insurance policies for 2010 varied only slightly above those policies in 2009. Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. In addition, Avista has removed a total of 10% of the total Directors' and Officers' insurance expense as ordered in Docket No. UG-090135. This adjustment decreases Washington net operating income by $12,000.

The last column on page 9, **Pro Forma Total**, reflects total pro forma results of operations and rate base consisting of twelve-months ended December 31, 2009 actual results and the total of all normalizing and pro forma adjustments.

Q. Referring back to page 1, line 44, of Exhibit No._____(EMA-3), what was the actual and pro forma gas rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 5.93%. The pro forma rate of return is 5.68% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.33% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington gas operations to allow the Company an opportunity to earn its proposed 8.33% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $5,275,000, as shown on line 5, page 2 of Exhibit No._____(EMA-3). The resulting revenue requirement is shown on line 7 and amounts to $8,489,000, or an increase of 5.38% over pro forma general business and transportation revenues.

V. ALLOCATION PROCEDURES

Q. Have there been any changes to the Company's system and jurisdictional procedures since the Company's last general electric and natural gas cases, Docket Nos. UE-090134 and UG-090135?

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

VI. APPROPRIATENESS & NORMALIZATION OF INCENTIVE COSTS

Q. In its Order No. 10 in Docket Nos. UE-090134 and UG-090135, the Commission directed the Company and all interested parties to review the employee incentive program for a more thorough evaluation of how the incremental cost of employee incentives should be treated in rates, and whether these costs should be normalized. Please discuss Avista's perspective on these issues.

A. As discussed in detail in Ms. Feltes' direct testimony, it is appropriate to include in rates the cost of the incentive plan expenses because there is a direct benefit to our customers. As Ms. Feltes explains, Avista's current incentive plan was designed in 2002. The goal of the incentive plan is to focus on three key elements, cost control, customer satisfaction and the reliability of the energy we provide to our customers. To achieve that goal, the plan was designed to focus the organization on efficient processes in every area. Accordingly, we have re-engineered and centralized many operational areas that have created greater satisfaction for customers and improved internal costs associated with delivering services. The Company's employee incentive plan, as designed, provides several specific benefits to our customers, notably:

- First, the plan focuses work groups and individuals on the key objectives of the Company, including reliability, customer service and operational efficiency, directly benefiting customers, and overall operational efficiency which translates into rates that are lower than they otherwise would be.
- Second, the plan slows the base wage growth that would occur in a compensation system with base salaries only. A compensation program without pay-at-risk would drive base wages upward which in turn would increase the fixed cost of base salaries overtime and significantly impact pension liability. By having a pay-at-risk component, the Company can keep overall costs lower for our customers.
- Third, the plan is part of a comprehensive compensation and benefits package provided to employees that makes Avista an attractive employer to skilled, experienced talent in the marketplace. Being competitive with our compensation

> and benefit programs is essential to recruiting and retaining quality employees. Customers directly benefit from the contributions of a strong workforce that provides high-quality and efficient service.

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

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

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

However, although the inclusion of the current incentive plan expenses have not been opposed for inclusion in the Company's rates collected from customers over the past several cases, there has been disagreement between the parties over the use of, or calculation of, an average or normalization of incentive expenses since the 2007 electric and gas GRCs.

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

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

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

Q. How did Staff's proposal above differ from that proposed by the Company in the subsequent 2008 and 2009 GRCs?

A. In the 2008 and 2009 electric and gas GRC proceedings (Docket Nos. UE-080416/UG-080417/UE-090134/UG-090135) the Company proposed a 6-year average (adjusted by an average inflation rate that reflects the Consumer Price Index (CPI). In 2008 the Company proposed a six-year average from 2002 (the start of the existing plan) through the actual 2007 test year, adjusted by the CPI. In 2009, the Company again proposed a six-year average, starting from 2003 through the actual 2008 test period, adjusted by the CPI. In each of these cases, the average adjustment amount increased the Company's revenue requirement.

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

A. Yes. Since annual Company incentive plan payouts can often vary year-to-year, the Company continues to believe an average of annual payouts is most appropriate in order to levelize these costs. Often where there are revenues or expenses that can vary significantly from year-to-year, the Commission has approved averages to properly reflect a fair and reasonable level of revenue or expense to be included in customers' rates. Utilizing a 6-year average of the Company's incentive plan results, (i.e. using years 2003 through 2008) include common incentive plans that are comparable from year-to-year, and is consistent with other averaging methods utilized by this Commission in past proceedings. For example, using the years 2003 through 2008 as proposed in the 2009 GRC, one can see the variability of the years and the impact of the 6-year average:

6-Year Average - 2009 GRC	
2003	$ 3,469,127
2004	$ 3,788,428
2005	$ 6,182,891
2006	$ 4,722,467
2007	$ 3,392,515
2008	$ 2,856,369
6 Yr Avg	$ 4,068,633
Test Year Incentive Exp.	$ 2,856,369
Pro Forma increase	$ 1,212,264

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

A. There are several examples of revenue or expense amounts which have been averaged or normalized and approved by this Commission. First, the Company has used a five-year average for OASIS wheeling revenues because these revenues vary year to year depending on electric energy market conditions. Avista has, in previous rate cases, used the most recent five-year average as being representative of future expectations unless there are known events or factors that occurred during the period that would cause the average to not be representative of future expectations. A second transmission revenue example includes the adjustment for Dry Gulch revenues. The current methodology used to normalize Dry Gulch revenue is a five-year average of actual revenue. A five-year average is used since the revenue can vary from year to year.

A third example includes the calculation of injuries and damages expense, which includes the restating adjustment described earlier in my testimony that replaces the amount accrued in the test period with a six-year rolling average of actual payments for injuries and damages not covered by insurance. Other examples of expenses where this Commission has approved the use of averages include power plant availability and storm damages.

Q. Briefly explain the reasoning behind the use of the CPI.

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

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

A. No, the Company did not. For this filing, Avista has included the actual level of incentive expense for the 2009 test period in its rate request, consistent with the Commission's most recent order which approved the use of the actual level for the test period. However, the

Company continues to believe that the use of an average would be the most appropriate method to determine incentives for ratemaking purposes. An adjusted six year average of incentives calculation (using years 2004 through 2009, adjusted for CPI - as proposed by the Company over the last few years), would result in a reduction to electric and gas A&G expense of approximately $367,000 and $103,000, respectively (Washington share), or a reduction to the Company's proposed electric and gas revenue requirement of $384,000 and $108,000, respectively. Therefore, given the arguments described above, the Company proposes that the Commission approve the Company's averaging method and include this adjustment in the ultimate outcome of this case.

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

A. Yes, it does.