

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-05 _____

DOCKET NO. UG-05 _____

DIRECT TESTIMONY OF

DON M. FALKNER

REPRESENTING AVISTA CORPORATION

CONTENTS

1			
2		<u>Section</u>	<u>Page</u>
3	I	Introduction	2
4	II	Combined Revenue Requirement Summary	4
5	III	Electric Section	4
6		Revenue Requirement	10
7		Standard Commission Basis Adjustments	11
8		Pro Forma Adjustments	20
9	IV	Natural Gas Section	26
10		Revenue Requirement	27
11		Standard Commission Basis Adjustments	28
12		Pro Forma Adjustments	34
13	V	Allocation Procedures	37
14		Exhibit No. ____ (DMF-2) – Electric Revenue Requirement and	
15		Results of Operations	(pgs 1-9)
16		Exhibit No. ____ (DMF-3) – Gas Revenue Requirement and	
17		Results of Operations	(pgs 1-8)
18			

1 **I. INTRODUCTION**

2 **Q. Please state your name, business address, and present position with Avista**
3 **Corp.**

4 A. My name is Don M. Falkner. My business address is 1411 East Mission Avenue,
5 Spokane, Washington. I am employed by Avista Corp., doing business as Avista Utilities
6 (“Avista” or “Company”) and my current position is Manager of Revenue Requirements in the
7 State and Federal Regulation Department.

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

9 A. I am a 1981 graduate of Washington State University with a Bachelor of Arts
10 Degree in Business Administration, majoring in Accounting. That same year, I sat for and
11 passed the May Certified Public Accountant exam. I joined the Company in June of 1981. I
12 have served in various positions within the sections of the Finance Department, including Power
13 Supply Accounting, Subsidiary Accounting, Budget and Forecasting, Plant Accounting and
14 Corporate Accounting. For the past 15 years, I have served in the State and Federal Regulation
15 Department. I have also attended several utility accounting and ratemaking courses.

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

17 A. As Manager of Revenue Requirements, aside from special projects, I am
18 responsible for preparation of normalized revenue requirement and pro forma studies for the
19 various jurisdictions in which the Company provides utility services. During the last 7 to 8 years
20 I have assisted in management and have been the lead rate analyst in the Company’s electric and
21 natural gas general rate filings in Washington, Idaho and Oregon.

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

1 A. My testimony and exhibits in this proceeding will generally cover accounting and
2 financial data in support of the Company's need for the proposed increase in rates. I will explain
3 pro forma operating results including expense and rate base adjustments made to actual
4 operating results and rate base. Mr. Hirschhorn will explain the pro forma revenue adjustments
5 and the pro forma adjustment related to moving the natural gas procurement functions from
6 Avista Energy back to the utility. Mr. Peterson will explain the proposed adjustments related to
7 the amortization costs associated with two Wartsila generating units, and the Kettle Falls
8 production tax credit. Mr. Johnson was responsible for the preparation of the pro forma power
9 supply adjustment. I will cover each of these adjustments briefly, and the other testimonies
10 provide a more in-depth discussion. While I provided the revenue requirement impact of the pro
11 forma vegetation management and pro forma transmission project adjustment, Mr. Kopczynski
12 provides additional operational detail and support regarding those adjustments.

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

14 A. Yes. I am sponsoring Exhibit No. ____ (DMF-2) and Exhibit No. ____ (DMF-
15 3), which were prepared under my direction.

16 **II. COMBINED REVENUE REQUIREMENT SUMMARY**

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

19 A. Yes. After taking into account all standard Commission Basis adjustments, as
20 well as additional pro forma and normalizing adjustments, the pro forma electric and natural gas
21 rates of return ("ROR") for the Company's Washington jurisdictional operations are 6.87% and
22 8.27%, respectively. Both return levels are below the Company's requested rates of return of

1 9.67%. The incremental revenue requirement necessary to give the Company an opportunity to
2 earn its requested ROR is \$35,833,000 for the electric operations and \$2,943,000 for the natural
3 gas operations. The overall electric increase is 12.52%, while the overall natural gas increase is
4 1.82%.

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

7 A. The Company's currently authorized rates of return for its Washington operations
8 are 9.72%, effective July 2002 for our electric system, and 8.68%, effective November 2004 for
9 our gas system.

10 **III. ELECTRIC SECTION**

11 **Changes Since the 2000 Test Period**

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

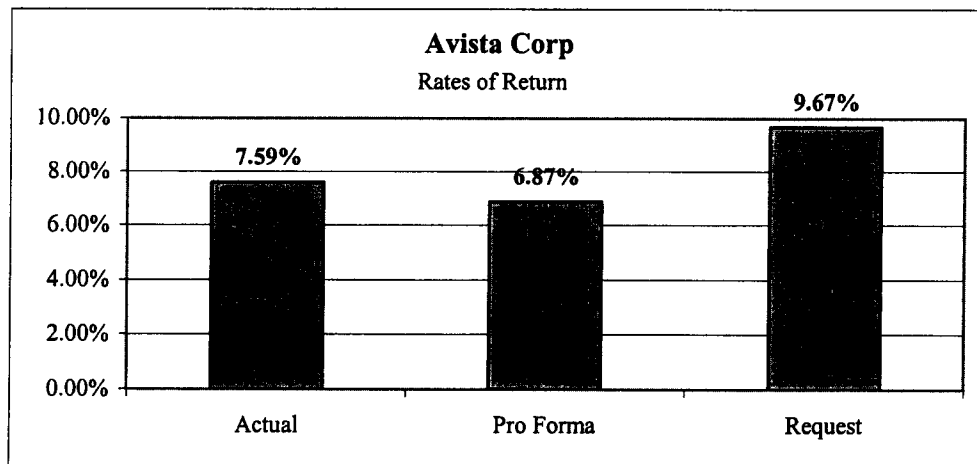
14 A. The test period being used by the Company is the twelve-month period ending
15 December 31, 2004, presented on a pro forma basis. Currently authorized rates are based upon
16 the 2000 test year utilized in UE-011595.

17 **Q. Have there been any changes to electric rates in the Washington jurisdiction**
18 **since the July 2002 rate change?**

19 A. No. The Company has not changed its base electric rates in Washington since
20 2002, and the Schedule 91 Tariff Rider Adjustment and Schedule 93 Power Cost Surcharge
21 associated with the Company's Energy Recovery Mechanism have also remained unchanged.

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

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

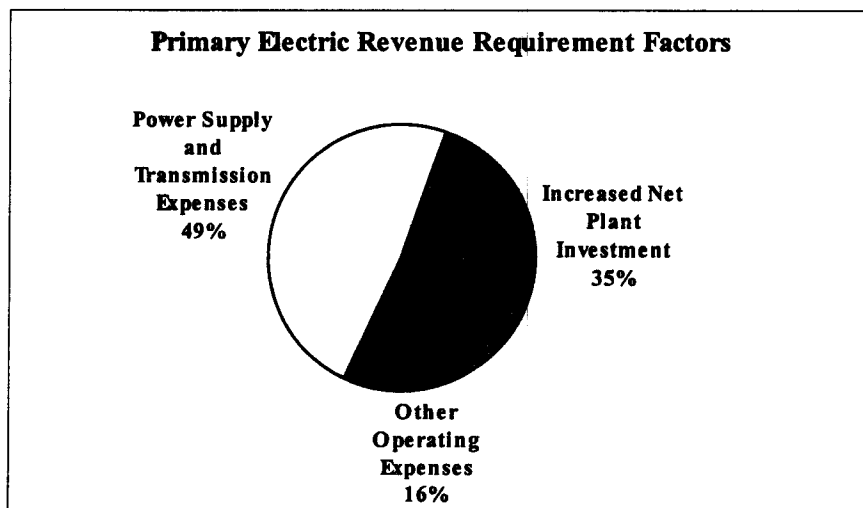


7
 8 **Q. What are the primary factors driving the Company's need for an electric**
 9 **increase?**

10 A. There are numerous operational factors that have impacted the Company's electric
 11 results of operations since the 2000 test year. Net Operating Income ("NOI") has declined
 12 approximately \$17 million, or 30%, and Total Rate Base has increased approximately \$56
 13 million, or 8%. During this same time period, the average number of customers has increased
 14 6%. The Company's electric request is driven by changes in various operating cost components,
 15 but primarily power supply costs, and plant investment or rate base growth associated with
 16 generation and transmission plant. Production and Transmission expense increases, as explained

1 below, comprise approximately 49% of the overall request. As already noted, net rate base
 2 increased approximately \$56 million, primarily due to additional plant investment in generation,
 3 both hydro and thermal, and transmission plant. Washington’s jurisdictional share of the
 4 addition of the second half of Coyote Springs 2 (“CS2”) was \$41 million alone. The depreciation
 5 recovery and the return on additional net plant investments make up approximately 35% of the
 6 Company request.

7 The net increase to all other operating categories, such as distribution, customer service,
 8 taxes and administrative and general, total the remaining 16%. I will provide additional detail
 9 regarding these items later, but the chart below shows this initial comparison:



10

11 **Q. Beyond power supply and transmission expenses and increased net plant,**
 12 **what are the main components of the “Other” segment shown in the chart above?**

13 **A.** As could be expected, a number of expense items have increased over the last four
 14 years since the last Washington electric increase. For example, as is true with many other
 15 utilities, pension and insurance costs have been on the rise. Payroll costs also have increased

1 over the last four years due to a slight growth in the number of employees, as well as the
2 increases in wages and benefits. Finally, due in part to regional and national concerns over
3 system reliability, the Company has increased its focus on vegetation management, or tree
4 trimming. Labor and benefit costs have increased approximately \$4.5 million.

5 **Q. You mentioned an offsetting impact due to revenue changes. How has the**
6 **Company's customer base changed since the 2000 test year?**

7 A. Yes. Average customer count for the Company's Washington electric jurisdiction
8 has increased from 206,207 to 218,520 at the end of 2004, or a 6% increase.

9 **Q. Was this increase in customer base accompanied by an associated increase in**
10 **total revenues?**

11 A. Yes, but only slightly. Total general business revenues increased only \$7.2
12 million. After taking into account the addition of 12,313 new customers, general business
13 revenues per customer have declined by a little over 3%, on a normalized basis.

14 **Q. Please describe the impact of increased net power supply expense?**

15 A. Net power supply expense is the sum of fuel expense and purchased power costs
16 less wholesale revenues, or sales for resale. The single largest cost category increase since the
17 Company's last rate case is the combination of fuel expense for the Company's steam plants and
18 combustion turbine units, which shows an increase of \$27 million. It is important to remember,
19 however, that individual power supply revenue and expense categories cannot be viewed in
20 isolation in analyzing the change in "net" power supply costs. For example, the increased fuel
21 (natural gas) costs to run Coyote Springs 2 resulted in a substantial increase in thermal generation
22 at a cost of \$41.84/mWh (Exhibit No. ____ (WGJ-4)). The weighted average wholesale electric

1 market price that corresponds with the increased CS2 generation is \$47.70/mWh. Therefore,
2 when the increased CS2 generation is taken into consideration, the additional CS2 generation
3 actually results in a decrease in net power supply costs, all other things being equal. Mr. Johnson
4 explains the primary factors driving the increases in net power supply costs. Some of those
5 factors include the loss of some low-cost mid-Columbia generation, the expiration of a favorably
6 priced long-term wholesale sales contract, and increased transmission and natural gas
7 transportation costs.

8 **Q. Could you please identify some of the other categories that have contributed**
9 **to the Company's filed revenue requirement?**

10 A. Certainly. Depreciation expense, which has largely followed a 16% growth in
11 gross plant-in-service, has increased \$7.4 million. Production and Transmission O&M has
12 increased \$6.2 million, and has been impacted primarily by maintenance contracts associated
13 with operation of the increased ownership of Coyote Springs 2 plant, and wheeling cost changes.
14 We are utilizing a 2004 test year since that is the most recent normalized financial information
15 the Company has available, however, new general electric rates resulting from this filing will not
16 go into effect until early in 2006. Accordingly, the Company has included a number of pro forma
17 adjustments to capture some of the measurable cost changes that the Company will experience
18 from the 2004 test year. Two of those adjustments were cost decreases associated with pension
19 costs and insurance costs since those expenses have fallen slightly from the test year.

20 **Q. How did you determine the revenue requirement associated with the increase**
21 **in rate base?**

1 A. Total Rate Base increased \$56 million. This net figure is the gross plant increase
2 less the offsetting increases in accumulated depreciation and deferred income taxes. The rate
3 base growth results in an increase of \$8.7 million using the requested 9.67% ROR.

4 **Q. What were the major components of the \$56 million increase in Total Rate**
5 **Base?**

6 A. Looking at the changes to “gross” plant in service shows that gross plant increased
7 \$189 million, or a little over 16%. To continue to meet the energy and reliability needs of our
8 customers, the Company has invested additional amounts in thermal and hydro generating
9 facilities, as well as additional transmission investment, which combined make up approximately
10 62% of the increases in gross plant. Specifically, the investments in the second half of CS2
11 added \$41 million, which is Washington’s jurisdictional share of the \$62.5 million gross plant
12 cost. Necessary upgrades to the Company’s Cabinet Gorge hydroelectric project have also been
13 completed and captured in the 2004 test period. The generating capacity from these projects was
14 included in the Company’s pro forma power supply calculation.

15 By itself, the additional transmission investment increased gross Washington electric
16 plant by \$50.6 million, with \$18.5 million of that amount being projects scheduled to be
17 completed in 2005. Mr. Ron Peterson discusses the need for and reasonableness of the new
18 generation, while Mr. Kopczynski addresses the transmission upgrades. Later in my testimony, I
19 will address the detail behind the normalizing and pro forma net operating income and rate base
20 impact of these adjustments. Distribution plant increased \$16.4 million, or 14%, while
21 Intangible and General plant increased a combined \$11 million.

1 The figures listed above are “gross” plant investment changes. Again, taking into account
2 increases to Accumulated Depreciation and Amortization and Deferred Federal Income Tax
3 offsets, produces the net \$56 million, or 8% increase to Total Rate Base.

4 **Revenue Requirement**

5 **Q. Would you please explain what is shown in Exhibit No. ____ (DMF-2)?**

6 A. Exhibit No. ____ (DMF-2) shows actual and pro forma electric operating results
7 and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit
8 No. ____ (DMF-2) shows 2004 operating results and components of the average-of-monthly-
9 average rate base as recorded; column (c) is the total of all adjustments to net operating income
10 and rate base; and column (d) is pro forma results of operations, all under existing rates. Column
11 (e) shows the revenue increase required which would allow the Company to earn a 9.67% rate of
12 return. Column (f) reflects pro forma electric operating results with the requested increase of
13 \$35,833,000. The restating adjustments shown in columns *b* through *ac* are consistent with the
14 treatment reflected in prior Commission Orders in Docket Nos. UE-991606 and UE-011595.

15 **Q. Would you please explain page 2 of Exhibit No. ____ (DMF-2)?**

16 A. Yes. Page 2 shows the calculation of the \$35,833,000 revenue requirement at the
17 requested 9.67% rate of return.

18 **Q. Would you now please explain page 3 of Exhibit No. ____ (DMF-2)?**

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

1 **Q. Now turning to pages 4 through 9 of your Exhibit No. ____ (DMF-2), would**
2 **you please explain what those pages show?**

3 A. Page 4 begins with actual operating results and rate base for the 2004 test period
4 in column (b). Individual normalizing adjustments that are standard components of our annual
5 reporting to the Commission begin in column (c) on page 4 and continue through column (u) on
6 page 7. Individual pro forma and additional normalizing adjustments begin in column (PF1) on
7 page 7 and continue through column (PF11) on page 9. The final column on page 9 is the total
8 pro forma operating results and rate base for the test period.

9

10 **Standard Commission Basis Adjustments**

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

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

17 The first adjustment, column (c) on page 4, entitled **Deferred FIT Rate Base**, reflects the
18 rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the
19 deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery
20 System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing
21 premiums, and contributions in aid of construction. These amounts are reflected on an ending
22 balance basis. The effect on Washington rate base is a reduction of \$150,785,000.

1 Column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for
2 Washington's portion of the net of tax, unamortized gain on the sale of the Company's general
3 office facility. The facility was sold in December 1986 and leased back by the Company. This
4 adjustment reflects the average of monthly averages amount of the deferred gain for the 2006 rate
5 period. The effect on Washington rate base is a reduction of \$465,000.

6 Column (e), **Colstrip 3 AFUDC Elimination**, is a reallocation of rate base and
7 depreciation expense between jurisdictions. In Cause Nos. U-81-15 and U-82-10, the WUTC
8 allowed the Company a return on a portion of Colstrip Unit 3 construction work in progress
9 ("CWIP"). A much smaller amount of Colstrip Unit 3 CWIP was allowed in rate base in Case
10 U-1008-144 by the Idaho Public Utilities Commission ("IPUC"). The Company eliminated the
11 AFUDC associated with the portion of CWIP allowed in rate base in each jurisdiction. Since
12 production facilities are allocated on the Production/Transmission formula, the allocation of
13 AFUDC is reversed and a direct assignment is made. The rate base adjustment reflects the
14 average of monthly averages amount for the 2006 rate period. The effect on Washington net
15 operating income is an increase of \$221,000. The effect of the reallocation on Washington rate
16 base is a decrease of \$2,302,000.

17 The adjustment in column (f), **Colstrip Common AFUDC**, is also associated with the
18 Colstrip plants in Montana, and increases rate base. Differing amounts of Colstrip common
19 facilities were excluded from rate base by this Commission and the IPUC until Colstrip Unit 4
20 was placed in service. The Company was allowed to accrue AFUDC on the Colstrip common
21 facilities during the time that they were excluded from rate base. It is necessary to directly assign
22 the AFUDC because of the differing amounts of common facilities excluded from rate base by

1 this Commission and the IPUC. In September 1988, an entry was made to comply with a Federal
2 Energy Regulatory Commission (“FERC”) Audit Exception, which transferred Colstrip common
3 AFUDC from the plant accounts to account 186. These amounts reflect a direct assignment of
4 rate base for the appropriate average of monthly averages amounts of Colstrip common AFUDC
5 to the Washington and Idaho jurisdictions. Amortization expense associated with the Colstrip
6 common AFUDC is charged directly to the Washington and Idaho jurisdictions through Account
7 406 and is a component of the actual results of operations. The rate base adjustment reflects the
8 average of monthly averages amount for the 2006 rate period. The effect on Washington rate
9 base is an increase of \$492,000.

10 The adjustment in column (g), **Kettle Falls Disallowance**, decreases rate base. The
11 amounts reflect the Kettle Falls generating plant disallowance ordered by this Commission in
12 Cause No. U-83-26. The disallowed investment and related accumulated depreciation, FIT
13 expense, accumulated depreciation and accumulated deferred FIT are removed from actual
14 results of operations. The rate base adjustment reflects the average of monthly averages amount
15 for the 2006 rate period with accumulated deferred FIT being the balance at 12/31/06. The effect
16 on Washington net operating income is an increase of \$79,000. The effect on Washington rate
17 base is a decrease of \$1,021,000.

18 The adjustment in column (h), entitled **Customer Advances**, decreases rate base for
19 moneys advanced by customers for line extensions, as they will most likely be recorded as
20 contributions in aid of construction at some future time. The effect on Washington rate base is a
21 decrease of \$223,000.

1 The **Settlement Exchange Power** adjustment in column (i) reflects the rate base
2 associated with the recovery of 64.1% of the Company's investment in Settlement Exchange
3 Power. The 64.1% recovery level was approved by the Commission's second Supplemental
4 Order in Cause No. U-86-99 dated February 24, 1987. Amortization expense and deferred FIT
5 expense recorded during the test period are reflected in results of operations. The rate base
6 adjustment reflects the average of monthly averages amount for the 2006 rate period with
7 accumulated deferred FIT being the balance at 12/31/06. The effect on Washington rate base is
8 an increase of \$26,681,000.

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

10 A. The column marked by a dash, entitled **Subtotal Actual** represents actual
11 operating results and rate base plus the standard rate base adjustments that are included in
12 Commission Basis reporting, but not generally calculated in the Company's monthly
13 jurisdictional Results of Operations reports.

14 The adjustment in column (j), **Hydro Relicensing Adjustment**, directly assigns
15 protection, mitigation and enhancement expenses to the Washington and Idaho jurisdictions and
16 reverses the allocation of these costs reflected in actual results of operations. This is necessary
17 due to differing regulatory treatment in Idaho Case No. WWP-E-98-11 and Washington Docket
18 No. UE-991606. The effect on Washington net operating income is a decrease of \$3,000.

19 Column (k), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated
20 with local business and occupation (B & O) taxes, which the Company is allowed to pass through
21 to its Washington customers. The adjustment eliminates any timing mismatch that exists
22 between the revenues and expenses by eliminating the revenues and expenses in their entirety. B

1 & O taxes are passed through on a separate schedule, which is not part of this proceeding. The
2 effect of this adjustment is to increase Washington net operating income by \$641,000.

3 Column (l), entitled **Property Tax**, restates the 2004 test period accrued levels of
4 property taxes to the most current information available and eliminates any adjustments related to
5 the prior year. The effect of this particular adjustment is to decrease Washington net operating
6 income by \$67,000.

7 Column (m), **Uncollectible Expense**, restates the accrued expense to the actual level of
8 net write-offs for the test period. The effect of this adjustment is to increase Washington net
9 operating income by \$88,000.

10 Column (n), **Regulatory Expense**, restates recorded 2004 regulatory expense to reflect
11 the WUTC assessment rates applied to revenues for the test period and the actual levels of FERC
12 fees paid during the test period. The effect of this adjustment is to increase Washington net
13 operating income by \$203,000.

14 Column (o), **Injuries and Damages**, is a restating adjustment that replaces the accrual
15 with actuals to obtain the six-year rolling average of injuries and damages payments not covered
16 by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company
17 changed to the reserve method of accounting for injuries and damages not covered by insurance.
18 The effect of this adjustment is to decrease Washington net operating income by \$70,000.

19 Column (p), **FIT**, is required to reflect the appropriate level of federal income tax
20 expense for the test period. This adjustment removes the effect of certain Schedule M items,
21 matches the jurisdictional allocation of other Schedule M items to related Results of Operations
22 allocations and eliminates any prior period income tax expense. This adjustment also reflects the

1 proper level of deferred tax expense for the test period. The effect of this adjustment, all based
2 upon a Federal tax rate of 35%, is to increase Washington net operating income by \$819,000.

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

4 A. Column (q), **Eliminate WA ERM Surcharge & Deferrals**, removes the effects
5 of the financial accounting for the Energy Recovery Mechanism (ERM.) The ERM normalizes
6 and defers certain power supply costs pursuant to the deferral and recovery mechanisms
7 authorized in Docket No. UE-011595. The adjustment removes the ERM surcharge revenue as
8 well as the deferral and amortization amounts and certain directly assigned power costs
9 associated with the ERM. The effect of this adjustment is to decrease Washington net operating
10 income by \$4,909,000.

11 Column (r), entitled **Nez Perce Settlement Adjustment**, reflects an increase in
12 Production operating expenses. An agreement was entered into between the Company and the
13 Nez Perce Tribe to settle certain issues regarding earlier owned and operated hydroelectric
14 generating facilities of the Company. This adjustment directly assigns the Nez Perce Settlement
15 expenses to the Washington and Idaho jurisdictions. This is necessary due to differing regulatory
16 treatment in Idaho Case No. WWP-E-98-11 and Washington Docket No. UE-991606. This
17 restating adjustment is consistent with Docket No. UE-011595. The effect of this adjustment is
18 to decrease Washington net operating income by \$8,000.

19 Column (s), **Payroll Clearing**, adjusts the payroll loading costs (benefits, payroll taxes
20 and paid time off) expensed through a clearing account during the 2004 test period, to the actual
21 payroll loading costs for the test period. The estimated payroll loading rates during the 2004 test
22 period produced an expense level greater than the actual amount of employee benefits incurred

1 for the test period. This adjustment is consistent with Docket No. UE-011595. The impact of
2 this adjustment on the Washington electric jurisdiction increases net operating income by
3 \$1,055,000.

4 **Coyote Springs 2**, addressed in column (t), reflects expenses and rate base associated
5 with the purchase of the second half of Coyote Springs 2 as well as a backup transformer that
6 was purchased for the project, for a full year. The impact of this adjustment increases
7 Washington rate base by \$41,001,000 and decreases Washington net operating income by
8 \$2,505,000.

9 Column (u), **PGE Monetization**, adds the amortization and related rate base reduction
10 associated with the interest component of the PGE Monetization per Docket No. UE-991606.
11 The rate base adjustment is the average of monthly averages amount for the 2006 rate period with
12 accumulated deferred FIT being the balance at 12/31/06. This adjustment decreases Washington
13 rate base by \$2,907,000 and increases Washington net operating income by \$1,154,000.

14 Column (v), **Eliminate A/R Expenses**, A/R representing Accounts Receivable, removes
15 expenses associated with the sale of customer accounts receivable. The effect of this adjustment
16 is to increase Washington net operating income by \$472,000.

17 Column (w), **Office Space Charged to Subs**, removes a portion of the office space costs
18 (building lease and O&M costs, common area costs, copier expense and annual office furniture
19 rental) using the relationship of labor hours charged to subsidiary activities by employee
20 compared to total labor hours by employee. These percentages are applied to the employees'
21 office space (expressed in square feet) and multiplied by office space costs/per square foot. This
22 restating adjustment is made as a result of the Commission's Third Supplemental Order in

1 Docket No. U-88-2380-T and is consistent with Docket Nos. UE-991606 and UE-011595. The
2 effect of this adjustment is to increase Washington net operating income by \$16,000.

3 **Q. Please continue on page 7 with your explanations of the adjustments.**

4 A. Column (x), **Restate Excise/Franchise Taxes**, removes the effect of a one-month
5 lag between collection and payment of taxes. It should be noted that the City of Millwood
6 franchise fee expired on June 4, 2004 and accordingly, has been eliminated from the Company's
7 pro forma results of operations. The effect of this adjustment is to increase Washington net
8 operating income by \$39,000.

9 Column (y), **Revenue Adjustment**, is a 3-fold adjustment taking into account known and
10 measurable changes that include revenue normalization, weather normalization and a
11 recalculation of unbilled revenue. The revenue normalization includes corrections for rate
12 schedule shifts. Mr. Hirschorn is sponsoring this adjustment. The effect of this particular
13 adjustment is to increase Washington net operating income by \$921,000.

14 Column (z), **Remove Misc Tariffs Adjustments**, eliminates the revenues and expenses
15 associated with two miscellaneous tariffs where the Company is allowed to pass through to its
16 Washington customers certain regulatory credits and charges. Specifically, Schedule 59-
17 Residential Exchange and Schedule 91-DSM Tariff Rider. The adjustment eliminates any timing
18 mismatch that exists between the revenues and expenses by eliminating the revenues and
19 expenses in their entirety. These separate schedules are not part of this proceeding. The effect of
20 this adjustment is to decrease Washington net operating income by \$5,000.

21 Column (aa), **Depreciation Adjustment**, removes the impact of out-of-period corrections
22 from 2004 recorded depreciation expense and records the 2004 true-up to end-of-year

1 depreciation recorded in January of 2005, thus adjusting depreciation expense and accumulated
2 depreciation to the appropriate levels at December 31, 2004. This adjustment decreases
3 Washington net operating income by \$1,048,000 and increases Washington rate base by
4 \$251,000.

5 Column (ab), **Incentives and Other Adjustment**, adjusts 2004 test year incentive
6 expense to the actual 2004 incentive expense paid in 2005 for the 2004 incentive plan. The
7 Company's main employee incentive plan uses Customer Satisfaction and Reliability targets as
8 the initial step in issuing incentive payouts. Actual payouts are dictated by O&M cost savings at
9 the individual department level. Since the executive plan is slightly different than the main
10 employee incentive plan, this adjustment removes any part of the 2004 executive incentive
11 payout that was "not" based on the Customer Satisfaction and Reliability targets. The impact of
12 a 2004 executive severance expense accrual was also removed from utility operations. The
13 impact of this adjustment on Washington net operating income is a decrease of \$33,000.

14 Column (ac), **Restate Debt Interest**, restates debt interest using the Company's pro
15 forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Malquist,
16 and applied to Washington's pro forma level of rate base, produces a pro forma level of tax
17 deductible interest expense. The Federal income tax effect of the restated level of interest for the
18 test period decreases Washington net operating income by \$2,661,000.

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

1 **Pro Forma Adjustments**

2 **Q. Please explain the significance of the 11 columns subsequent to column (ad)**
3 **that begin at the end of page 7 in your Exhibit No. ____ (DMF-2).**

4 A. Certainly. The adjustments subsequent to column (ad) are pro forma adjustments
5 that recognize the jurisdictional impacts of material items that will impact the pro forma
6 operating period levels for known and measurable changes. They encompass both expense items
7 as well as significant capital projects. These adjustments bring the operating results and rate base
8 to the final pro forma level for the rate year.

9 **Q. Please continue with your explanation of the adjustments beginning with the**
10 **last column on page 7.**

11 A. Column (PF1), **Pro Forma Power Supply**, was made under the direction of Mr.
12 Johnson and is explained in detail in his testimony. This adjustment normalizes power supply
13 related revenue and expenses to reflect the twelve-month period January 1, 2006 through
14 December 31, 2006. Mr. Johnson testimony outlines the system level of pro forma power supply
15 details that are included in this adjustment. This adjustment calculates the Washington
16 jurisdictional share of those figures, and also eliminates an offsetting direct assignment of certain
17 power supply costs included in the base Results of Operations. The net effect of the power
18 supply adjustments decreases Washington net operating income by \$4,465,000.

19 Column (PF2), **Pro Forma Pension**, reduces the actual 2004 pension expense to the
20 expense accrual projection for 2005. Pension expense, on a system basis, was \$13.9 million
21 during the 2004 test year, however the 2005 accrual has decreased to \$11.8 million annually.
22 Pension costs that are properly charged to non-utility labor costs have also been excluded from

1 this adjustment. The effect of this adjustment is to increase Washington net operating income by
2 \$377,000.

3 **Q. Please describe the Company's pension expense?**

4 A. The Company's pension expense has consistently been determined in accordance
5 with Financial Accounting Standard 87 ("FAS-87") since that standard's implementation date of
6 January 1, 1987. Pension expense is determined by an outside actuarial firm, in accordance with
7 FAS-87, and the calculations and assumptions are reviewed by the Company's outside
8 accounting firm for reasonableness and comparability to other companies.

9 As is being experienced by many companies with funded pension plans, pension costs
10 have increased due primarily to the investment performance of plan assets during the major
11 downturn in the equity markets experienced in the last few years. Pension expense, as with other
12 employee benefits, is "loaded" onto actual labor costs, which are then assigned to various
13 functional expense categories and accounts through the payroll process. Historically,
14 approximately 60% of labor goes to expense and 40% to capital. In our adjustment, a detailed
15 analysis of 2004 labor charges was performed to more accurately determine the Washington
16 electric percentage of overall labor.

17 **Q. Please continue with your discussion of the adjustments starting with column**
18 **PF3 on page 8?**

19 A. Column (PF3), **Pro Forma Insurance**, updates the 2004 insurance expense for
20 general liability, directors and officer liability, property insurance and other policies, to the actual
21 cost of all "signed, ongoing and renewed" policies providing insurance for 2005. Insurance costs
22 are mainly expensed at a system level and allocated to electric and gas. Insurance costs that are

1 properly charged to non-utility operations have been excluded from this adjustment. The effect
2 of this adjustment increases Washington net operating income by \$244,000.

3 Column (PF4), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to
4 test period union and non-union wages and salaries, excluding executive salaries, which are
5 handled separately in PF5. Test period wages and salaries are restated as if the wage and salary
6 increases through March 2006 were in place during the entire pro forma test period. The
7 methodology behind this adjustment is consistent with UE-011595 and is similar to Docket No.
8 UE-99106. The effect of this adjustment on Washington net operating income is a decrease of
9 \$1,326,000.

10 Column (PF5), **Pro Forma Labor-Executive**, reflects known and measurable changes to
11 executive compensation, restating their salaries as if wage and salary increases through March
12 2006 were in place for the entire pro forma test period. This adjustment takes into account
13 changes in executive staffing made during 2004 and includes compensation for the current
14 executive team only. Compensation costs for non-utility operations are excluded as executives
15 routinely charge a portion of their time to non-utility operations, commensurate with the amount
16 of time spent on such activities. The current executives' salary allocations are set at their
17 expected pro forma test period utility/non-utility percentage splits. The impact of this adjustment
18 on Washington net operating income is a decrease of \$36,000.

19 Column (PF6), **Pro Forma Vegetation Management**, updates the 2004 tree trimming
20 expenditures to a level Company operational personnel have determined is necessary for the
21 proper management of vegetation around both transmission and distribution lines to most
22 effectively maintain reliability levels. Mr. Kopczynski is sponsoring testimony that details the

1 Company's vegetation management plans and the planned expenditure levels. The effect of this
2 adjustment decreases Washington net operating income by \$320,000.

3 Column (PF7), **Pro Forma Transmission Projects**, pro forms in a portion of the
4 capital cost and expenses associated with the major transmission project upgrades underway by
5 the Company. These upgrades are a multi-year project estimated to exceed \$100 million and is
6 being undertaken by the Company to increase transfer capability and improve reliability on our
7 transmission system. Again, Mr. Kopczynski is sponsoring testimony that details the overall
8 project. The entire project is actually broken down into a number of sub-projects that become
9 used and useful at different times. In this adjustment, three specific projects with estimated
10 system costs and completion dates in 2005 have been included and are shown in the table below:

11	<u>Project</u>	<u>Cost</u>	<u>In-Service Date</u>
12	Dry Creek 203 kV Substation.....	\$11,385,000	May 2005
13	Boulder 203 kV Substation.....	\$16,032,000	August 2005
14	Beacon – Bell #4 230 kV line.....	\$1,041,000	December 2005

15 Because of their near-term completion dates, these projects are expected to be completed and
16 transferred to plant-in-service by the time new rates are expected to be approved. The capital
17 costs have been averaged for a full 12-month pro forma period with the associated depreciation
18 expense and property tax, as well as the appropriate accumulated depreciation and deferred
19 income tax rate base offsets. The effect of this adjustment decreases Washington net operating
20 income by \$463,000 and increases rate base by \$17,997,000.

21 Column (PF8), **Sale of Skookumchuck Hydro**, removes the impact of the
22 Skookumchuck hydroelectric facility from the pro forma period. Skookumchuck dam was

1 constructed in 1973 as a water storage facility for the coal-fired Centralia Steam Plant, which was
2 sold in 2000. Avista obtained regulatory approvals to sell its 17.5% minority interest in the
3 Skookumchuck facility and the sale as recorded in October of 2004. The effect of this
4 adjustment increases Washington net operating income by \$32,000 and decreases rate base by
5 \$163,000.

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

7 A. Column (PF9), **Cancelled Small Generation**, pro forms amortization of the
8 expected level of unrecovered capital costs associated with a cancelled small generation project
9 at Spokane Industrial Park. Mr. Peterson provides additional detail regarding this project. The
10 effect of this adjustment decreases Washington net operating income by \$199,000.

11 Column (PF10), **Pro Forma Production Tax Credit**, reflects the impact of a federal
12 income tax credit related to generation at the Company's Kettle Falls wood waste generating
13 plant. This adjustment is discussed in further detail in Mr. Peterson's testimony. The impact of
14 this adjustment on Washington net operating income is an increase of \$992,000.

15 Column (PF11), **Allocation Adjustment**, reflects the impact of reallocating costs as a
16 result of the pending sale of the Company's California gas distribution properties, which was
17 approved by the California Public Utilities Commission on March 17, 2005. Final closing and
18 transfer of ownership is anticipated to occur by the end of April. The Company did not change
19 its 4-Factor allocation methodology. It only eliminated the impact of the California jurisdiction
20 from the 2004 allocations. The impact of this adjustment on Washington net operating income is
21 a decrease of \$347,000.

1 The last column, Pro Forma Total, reflects total 2004 pro forma results of operations and
2 rate base consisting of 2004 actual results and the total of all adjustments.

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

6 A. For the State of Washington, the actual test period rate of return was 7.59%. The
7 test period pro forma rate of return is 6.87% under present rates. Thus, the Company does not,
8 on a pro forma basis for the test period, realize the 9.67% rate of return requested by the
9 Company in this case.

10 **Q. How much additional net operating income would be required for the State**
11 **of Washington electric operations to allow the Company an opportunity to earn its**
12 **proposed 9.67% rate of return on a pro forma basis?**

13 A. The net operating income deficiency amounts to \$22,274,000, as shown on line 5,
14 page 2 of Exhibit No. ____ (DMF-2). The resulting revenue requirement is shown on line 7 and
15 amounts to \$35,833,000, or an increase of 12.52% over pro forma general business revenues.

16

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

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, 2004, 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 November 2, 2004 as a result of a settlement in Docket No. UG-041515 (Settlement), and was based on a 2003 test year.

Q. Would you please explain why the Company is filing a gas general rate case five months after the Settlement rates were implemented from the last gas case?

A. As I noted in my pre-filed testimony in the UG-041515 case for our Washington natural gas operations, the Company's 2002 normalized rate of return for 2002 was 5.22% and the Pro Forma ROR using the 2003 test year was 5.79%--both substantially below the then authorized ROR of 9.03% and the requested 9.86% ROR. The Settlement resulted in a revenue increase of approximately \$5.4 million compared to the initial request of approximately \$8.6 million. As part of the Settlement, pro forma adjustments were excluded. Additionally, a rate of return of 8.68% was accepted for use in calculating the revenue requirement. The Company opted to settle the UG-041515 natural gas-only case, and then file a combined electric and gas case in which major issues, such as rate of return, could be decided. We have also updated the test year from 2003 to the more current 2004.

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

3 A. The Company's natural gas revenue requirement request is driven primarily by an
4 increase in the cost of capital. Specifically, the difference between the requested ROR of 9.67%
5 and the 8.68% ROR utilized in the previous Settlement results in an increased revenue
6 requirement of \$2.3 million. In addition, the revenue requirement impact of the pro forma
7 adjustments, which were excluded from the Settlement, is approximately \$560,000. Finally,
8 there are some small changes in normalized revenues and expenses between the 2003 and 2004
9 test years.

10 **Revenue Requirement**

11 **Q. Would you please explain what is shown in Exhibit No. ____ (DMF-3)?**

12 A. Exhibit No. ____ (DMF-3) shows actual and pro forma gas operating results and
13 rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit
14 No. ____ (DMF-3) shows 2004 operating results and components of the average-of-monthly-
15 average rate base as recorded; column (c) is the total of all adjustments to net operating income
16 and rate base; and column (d) is pro forma results of operations, all under existing rates. Column
17 (e) shows the revenue increase required which would allow the Company to earn a 9.67% rate of
18 return. Column (f) reflects pro forma gas operating results with the requested increase of
19 \$2,943,000.

20 **Q. Would you please explain page 2 of Exhibit No. ____ (DMF-3)?**

21 A. Yes. Page 2 shows the calculation of the \$2,943,000 revenue requirement at the
22 requested 9.67% rate of return.

1 **Q. Would you now please explain page 3 of Exhibit No. ____ (DMF-3)?**

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

5 **Q. Now turning to pages 4 through 8 of your Exhibit No. ____ (DMF-3), would**
6 **you please explain what those pages show?**

7 A. Page 4 begins with actual operating results and rate base for the 2004 test period
8 in column (b). Individual normalizing adjustments that are standard components of our annual
9 reporting to the Commission begin in column (c) on page 4 and continue through column (v) on
10 page 7. Individual pro forma and additional normalizing adjustments begin in column (PF1) on
11 page 7 and continue through column (PF7) on page 8. The final column on page 8 is the total pro
12 forma operating results and rate base for the test period.

13

14 **Standard Commission Basis Adjustments**

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

18 A. Yes, but before I begin, I will note that in addition to the explanation of
19 adjustments provided herein, the Company has also provided workpapers outlining additional
20 details related to each of the adjustments. The restating adjustments shown in columns *b* through
21 *ac* are consistent with the treatment reflected in prior Commission Orders in Docket Nos. UG-
22 991607 and UG-041515.

1 The first adjustment, column (c) on page 4, entitled **Deferred FIT Rate Base**, reflects the
2 rate base reduction for Washington's portion of deferred taxes. The adjustment reflects the
3 deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery
4 System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS), bond refinancing
5 premiums, and contributions in aid of construction. These amounts are reflected on an ending
6 balance basis. The effect on Washington rate base is a reduction of \$26,800,000.

7 Column (d), **Deferred Gain on Office Building**, reflects the rate base reduction for
8 Washington's portion of the net of tax, unamortized gain on the sale of the Company's general
9 office facility. The facility was sold in December 1986 and leased back by the Company. The
10 treatment of the gain on the sale follows the Commission's Order Granting Application in Cause
11 No. FR-86-150. This adjustment reflects the average of monthly averages amount of the deferred
12 gain for the 2006 rate period. The effect on Washington rate base is a reduction of \$158,000.

13 Column (e), **Gas Inventory**, reflects the adjustment to rate base for the average of
14 monthly average value of gas stored at the Company's Jackson Prairie underground storage
15 facility and the Plymouth LNG Plant. The effect on Washington rate base is an increase of
16 \$4,807,000.

17 Column (f), **Weatherization and DSM Investment**, includes in rate base the balance
18 (net of amortization) of company investments in natural gas demand side management (DSM)
19 and Weatherization consistent with Docket Nos. UG-991607 and UG-041515. Amortization
20 expense is restated to the 2006 level of expense and rate base is the balance at 12/31/06. The
21 effect of this adjustment is to increase Washington net operating income by \$63,000 and increase
22 rate base by \$1,120,000.

1 The adjustment in column (g), entitled **Customer Advances**, decreases rate base for
2 funds advanced by customers for line extensions, as they are generally recorded as contributions
3 in aid of construction at some future time. The effect of this adjustment is to increase
4 Washington net operating income by \$29,000. The effect on Washington rate base is a decrease of
5 \$1,000.

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

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

10 Column (h), entitled **Revenue Normalization & Gas Cost Adjustment**, is a 3-fold
11 adjustment taking into account known and measurable changes that include revenue
12 normalization, which reprices customer usage under presently effective rates, as well as weather
13 normalization and an unbilled revenue calculation. Associated gas costs are replaced with gas
14 costs computed using normalized volumes at the currently effective “weighted average cost of
15 gas,” or WACOG rates. Revenues associated with the Schedule 191 Tariff Rider are excluded
16 from pro forma revenues, and the related amortization expense is eliminated as well. Mr.
17 Hirschhorn is sponsoring this adjustment. The effect of this particular adjustment is to increase
18 Washington net operating income by \$3,758,000.

19 Column (i), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated
20 with local business and occupation taxes, which the Company is allowed to pass through to
21 customers. The adjustment eliminates any timing mismatch that exists between the revenues and
22 expenses by eliminating the revenues and expenses in their entirety. B & O Taxes are passed

1 through on a separate schedule, which is not part of this proceeding. The effect of this
2 adjustment is to increase Washington net operating income by \$29,000.

3 Column (j), **Property Tax**, restates the 2004 test period accrued levels of property taxes
4 to the most current information available and eliminates any adjustments related to the prior year.
5 The effect of this particular adjustment is to increase Washington net operating income by
6 \$40,000.

7 Column (k), **Uncollectible Expense**, restates the accrued expense to the actual level of
8 net write-offs for the test period. The effect of this adjustment is to increase Washington net
9 operating income by \$149,000.

10 Column (l), entitled **Regulatory Expense Adjustment**, restates recorded 2004 regulatory
11 expense to reflect the WUTC assessment rates applied to revenues for the test period. The effect
12 of this adjustment is to decrease Washington net operating income by \$17,000.

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

14 A. Column (m), **Injuries and Damages**, is a restating adjustment that replaces the
15 accrual with actuals to obtain the six-year rolling average of injuries and damages payments not
16 covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the
17 Company changed to the reserve method of accounting for injuries and damages not covered by
18 insurance. The effect of this adjustment is to increase Washington net operating income by
19 \$5,000.

20 Column (n), **FIT**, is required to reflect the appropriate level of federal income tax
21 expense for the test period. This adjustment removes the effect of certain Schedule M items,
22 matches the jurisdictional allocation of other Schedule M items to related Results of Operations

1 allocations and eliminates any prior period income tax expense. This adjustment also reflects the
2 proper level of deferred tax expense for the test period. The effect of this adjustment, all based
3 upon a Federal tax rate of 35%, is to increase Washington net operating income by \$99,000.

4 Column (o), **Payroll Clearing**, adjusts the payroll loading costs (benefits, payroll taxes
5 and paid time off) expensed through a clearing account during the 2004 test period, to the actual
6 payroll loading costs for the test period. The estimated payroll loading rates during the 2004 test
7 period produced an expense level greater than the actual amount of employee benefits incurred
8 for the test period. This adjustment is consistent with Docket No. UG-041515. The impact of
9 this adjustment on the Washington gas jurisdiction increases net operating income by \$315,000.

10 Column (p), **Eliminate A/R Expenses**, A/R representing Accounts Receivable, removes
11 expenses associated with the sale of customer accounts receivable. The effect of this adjustment
12 is to increase Washington net operating income by \$82,000.

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

21 Column (r), **Restate Excise/Franchise Taxes**, removes the effect of a one-month lag
22 between collection and payment of taxes. It should be noted that the City of Spokane gas

1 franchise fee expired on September 15, 2004 and accordingly, has been eliminated from the
2 Company's pro forma results of operations. The effect of this adjustment is to increase
3 Washington net operating income by \$749,000.

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

5 Column (s), **Lease Expense Adjustment**, restates the straight-line accrual of lease
6 payments for the Company's general office building to a cash basis. The effect of this adjustment
7 is to decrease Washington net operating income by \$19,000.

8 Column (t), **Depreciation Adjustment**, removes the impact of out-of-period corrections
9 from 2004 recorded depreciation expense and records the 2004 true-up to depreciation recorded
10 in January of 2005, adjusting depreciation expense and accumulated depreciation to the
11 appropriate levels at December 31, 2004. This adjustment decreases Washington net operating
12 income by \$313,000 and increases Washington rate base by \$47,000.

13 Column (u), **Incentives and Other Adjustment**, adjusts 2004 test year incentive expense
14 to the actual 2004 incentive expense paid in 2005 for the 2004 incentive plan. Additionally, the
15 adjustment removes the impact of a 2004 executive severance expense accrual from utility
16 operations. The impact of this adjustment on Washington net operating income is a decrease of
17 \$9,000.

18 Column (v), **Restate Debt Interest**, restates debt interest using the Company's pro forma
19 weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Malquist, and
20 applied to Washington's pro forma level of rate base, produces a pro forma level of tax
21 deductible interest expense. The federal income tax effect of the restated level of interest for the
22 test period decreases Washington net operating income by \$647,000.

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

5

6 **Pro Forma Adjustments**

7 **Q. Please explain the significance of the additional adjustments that begin on**
8 **the last column of page 7 of your Exhibit No. ____ (DMF-3).**

9 A. The adjustments starting with the last column on page 7 are pro forma
10 adjustments to reflect material known and measurable changes between the test period and the
11 pro forma period. In this case, they encompass only revenue and expense items, as there were no
12 significant natural gas capital projects. These adjustments bring the operating results and rate
13 base to the final pro forma level for the test year.

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

15 A. Column (PF1), **Pro Forma Pension**, reduces the actual 2004 pension expense to
16 the expense accrual projection for 2005. Pension expense, on a system basis, was \$13.9 million
17 during the 2004 test year, however the 2005 accrual has decreased to \$11.8 million annually.
18 Pension costs that are properly charged to non-utility labor costs have also been excluded from
19 this adjustment. The effect of this adjustment is to increase Washington net operating income by
20 \$115,000.

21 **Q. Please describe the adjustments on page 8.**

1 A. Column (PF2), **Pro Forma Insurance**, updates the 2004 insurance expense for
2 general liability, directors and officer liability, property insurance and other policies, to the actual
3 cost of all signed ongoing and renewed policies providing insurance for 2005. Insurance costs
4 are mainly expensed at a system level and allocated to electric and gas. Insurance costs that are
5 properly charged to non-utility operations have been excluded from this adjustment. The effect
6 of this adjustment increases Washington net operating income by \$73,000.

7 Column (PF3), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to
8 test period union and non-union wages and salaries, excluding executive salaries, which are
9 handled separately in PF4. Test period wages and salaries are restated as if the wage and salary
10 increases for through March 2006 were in place during the entire pro forma test period. The
11 methodology behind this adjustment is similar to what the Company used in Docket No. UG-
12 99107. The effect of this adjustment on Washington net operating income is a decrease of
13 \$408,000.

14 Column (PF4), **Pro Forma Labor-Executive**, reflects known and measurable changes to
15 executive compensation, restating their salaries as if wage and salary increases through March
16 2006 were in place for the entire pro forma test period. This adjustment takes into account changes
17 in executive staffing made during 2004 and includes compensation for the current executive team
18 only. Compensation costs for non-utility operations are excluded as executives routinely charge
19 a portion of their time to non-utility operations, commensurate with the amount of time spent on
20 such activities. The current executives' salary allocations are set at their expected pro forma test
21 period utility/non-utility percentage splits. The impact of this adjustment on Washington net
22 operating income is a decrease of \$12,000.

1 Column (PF5), **Gas Procurement**, reflects the impact of hiring the employees necessary
2 to manage the return of the natural gas procurement functions to the utility from Avista Energy.
3 Mr. Hirschorn explains this adjustment in more detail in his direct testimony. The impact of
4 this adjustment on Washington net operating income is a decrease of \$125,000.

5 Column (PF6), **Allocation Adjustment**, reflects the impact of reallocating costs as a
6 result of the pending sale of the Company's California gas distribution properties, which was
7 approved by the California Public Utilities Commission on March 17, 2005. Final closing and
8 transfer of ownership is anticipated to occur by the end of April. The Company did not change
9 its 4-Factor allocation methodology. It only eliminated the impact of the California jurisdiction
10 from the 2004 allocations. The impact of this adjustment on Washington net operating income is
11 a decrease of \$103,000.

12 Column (PF7), **Remove Hamilton St.**, reflects the impact of eliminating costs associated
13 with a remedial investigation of a former coal gasification plant site once owned by the company.
14 The company has elected not to pursue recovery of expected cleanup and other costs from its gas
15 customers. The impact of this adjustment on Washington net operating income is an increase of
16 \$110,000.

17 The last column on page 8, **Pro Forma Total**, reflects total 2004 pro forma results of
18 operations and rate base consisting of 2004 actual results and the total of all normalizing and pro
19 forma adjustments.

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

1 A. For the State of Washington, the actual test period rate of return was 4.53%. The
2 test period pro forma rate of return is 8.27% under present rates. Thus, the Company does not,
3 on a pro forma basis for the test period, realize the 9.67% rate of return requested by the
4 Company in this case.

5 **Q. How much additional net operating income would be required for the State**
6 **of Washington gas operations to allow the Company an opportunity to earn its proposed**
7 **9.67% rate of return on a pro forma basis?**

8 A. The net operating income deficiency amounts to \$1,830,000, as shown on line 5,
9 page 2 of Exhibit No. ____ (DMF-3). The resulting revenue requirement is shown on line 7 and
10 amounts to \$2,943,000, or an increase of 1.82% over pro forma general business and
11 transportation revenues.

12

13 **V. ALLOCATION PROCEDURES**

14 **Q. Have there been any changes to the Company's system and jurisdictional**
15 **procedures since the Company's last general electric and natural gas cases, Docket Nos.**
16 **UE-991606, UE-011595, UG-991607 and UG-041515?**

17 A. No. For ratemaking purposes, the Company allocates revenues, expenses and rate
18 base between electric and gas services and between Washington, Idaho, Oregon and California
19 jurisdictions where electric and/or gas service is provided. The current methodology was
20 implemented at the start of 1994 and has not changed. As a result of earlier reviews, the Staff
21 has found that the allocation system was being applied properly and produced the proper
22 allocation of financial data. Also as part of earlier reviews, Staff has stated that the Company's

1 rate base was properly allocated between jurisdictions. As was discussed earlier, the Company
2 has, consistent with the accepted allocation methodology, reflected the reallocation of costs
3 resulting from the sale of the Company's California gas distribution properties.

4 **Q. Does that conclude your pre filed direct testimony?**

5 **A. Yes, it does.**