

Exhibit No. \_\_\_\_ (DPK-1)  
Docket UE-090134/UG-090135  
and UG-060518 (consolidated)  
Witness: Danny P. Kermode

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

<b>WASHINGTON UTILITIES AND</b>	)	<b>DOCKETS UE-090134</b>
<b>TRANSPORTATION COMMISSION,</b>	)	<b>and UG-090135</b>
	)	<i>(consolidated)</i>
<b>Complainant,</b>	)	
	)	
<b>v.</b>	)	
	)	
<b>AVISTA CORPORATION, d/b/a</b>	)	
<b>AVISTA UTILITIES,</b>	)	
	)	
<b>Respondent.</b>	)	
.....	)	
	)	
<b>In the Matter of the Petition of</b>	)	<b>DOCKET UG-060518</b>
	)	<i>(consolidated)</i>
<b>AVISTA CORPORATION, d/b/a</b>	)	
<b>AVISTA UTILITIES,</b>	)	
	)	
<b>For an Order Authorizing</b>	)	
<b>Implementation of a Natural Gas</b>	)	
<b>Decoupling Mechanism and to Record</b>	)	
<b>Accounting Entries Associated With</b>	)	
<b>the Mechanism.</b>	)	
.....	)	
	)	

**TESTIMONY**

**OF**

**DANNY P. KERMODE**

**STAFF OF WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION**

**August 17, 2009**

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1 I. INTRODUCTION

2

3 Q. Please state your name and business address.

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

7

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

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

11

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

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

14

15 Q. Would you please describe your educational background?

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

21 In 1992 and 1993, I was a member of the faculty at the National Association  
22 of Regulatory Utility Commissioners (NARUC) Annual Regulatory Studies  
23 Program, held at Michigan State University in East Lansing, Michigan. I taught

1 classes in Financial and Regulatory Accounting Standards and in Deferred Tax  
2 Accounting. In 2008 and 2009, I was a member of the faculty at the NARUC Utility  
3 Rate School in San Diego, California In addition, in 2008 I taught regulatory  
4 accounting at the *Institute of Public Utilities' Advanced Regulatory Studies Program.*

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

10  
11 **Q. Please discuss your professional background.**

12 A. I am a financial professional with a CPA and 25-plus years experience that includes  
13 experience in private practice, industry, and government. I spent 10 years as a CPA  
14 in private practice in Phoenix, Arizona, from 1983 to 1993, where I was an expert  
15 witness in a number of utility cases before the Arizona Corporation Commission, the  
16 state's public utility regulatory body.

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

22 Since my employment at the Commission, I have testified in numerous cases  
23 including testifying in the last three PacifiCorp general rate cases, Dockets UE-

1 032065, UE-050684, and UE-061546 along with filing testimony in the UE-070804  
2 Avista case. I testified on accounting and income tax issues in the 2001 rate case  
3 involving Olympic Pipeline Company, Docket No. TO-011472. I also filed  
4 testimony in four water company general rate cases: American Water Resources,  
5 Docket No. UW-980258; Rainier View Water Co., Inc, Docket No. UW-010877;  
6 Marbello Water Company, Docket No. UW-041181, and Iliad Water Service, Inc.,  
7 Docket No. UW-060343. I filed testimony regarding income taxes in the Verizon  
8 Northwest, Inc. general rate case, Docket No. UT-040788.

## 10 II. SCOPE OF TESTIMONY

11  
12 **Q. What is the scope of your testimony?**

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

22 As the lead regulatory analyst for this case, it is my responsibility to present  
23 and explain Staff's pro forma results of operations. I will present among other

1 things, the computation of revenue conversion factor along with the derivation of  
2 Staff's recommended revenue requirement for both the electric and gas operations.

3

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

5 A. Yes. I have prepared Exhibit No. \_\_\_\_ (DPK-2) and Exhibit No. \_\_\_\_ (DPK-3). Both  
6 are multi-page exhibits that show Avista's test year ended September 30, 2008  
7 operating results for its Washington Electric Operations and Washington Natural Gas  
8 Operations, respectively. Included in Exhibit Nos. \_\_\_\_ (DPK-2) and (DPK- 3) are:

- 9 • Results of Operations Summary (Schedule 1.1);
- 10 • Schedule of Restating Adjustments (Schedule 1.2);
- 11 • Schedule of Pro forma Adjustments (Schedule 1.3);
- 12 • Summary of Adjustments (Schedule 1.4);
- 13 • Revenue Requirement Computation (Schedule 2);
- 14 • Revenue Conversion Factor (Schedule 3);
- 15 • Pro Forma Capital Structure and Cost of Capital (Schedule 4);

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

- 17 • Exhibit No. \_\_\_\_ (DPK-4), Pro Forma Interest Adjustment – Electric;
- 18 • Exhibit No. \_\_\_\_ (DPK-5), Pro Forma Interest Adjustment – Gas;
- 19 • Exhibit No. \_\_\_\_ (DPK-6), Production Property Adjustment Calculation –  
20 Electric;

21

1 **III. SUMMARY OF TESTIMONY**

2

3 **Q. Please summarize Staff's revenue requirement analysis for Avista's electric**  
4 **operations.**

5 A. Staff's revenue requirement analysis shows that Avista's electric operations, on a pro  
6 forma basis, are earning 6.88 percent return on its invested rate base. Staff's  
7 recommended authorized return on investment is 8.13 percent. As a result, Staff's  
8 analysis supports an additional electric revenue requirement of \$20,109,000, an  
9 overall increase in test year revenues of 5.15 percent.

10

11 **Q. Please summarize Staff's revenue requirement analysis for Avista's natural gas**  
12 **operations.**

13 A. Staff's revenue requirement analysis shows that Avista's natural gas operations, on a  
14 pro forma basis, are earning 8.03 percent return on its invested rate base. Staff's  
15 recommended authorized return on investment is 8.13 percent. As a result, Staff's  
16 analysis supports an additional gas revenue requirement of \$280,000, an overall  
17 increase in test year revenues of 0.13 percent.

18

19 **Q. What capital structure and cost of capital did you use in determining Avista's**  
20 **revenue requirements for both its electric and gas operations?**

21 A. I applied the capital structure and the financing costs recommended by Staff witness  
22 David Parcell for the capital structure and debt and equity components (*See Direct*  
23 *Testimony of David C. Parcell, Exhibit No. \_\_\_ T (DCP-1T)*). The calculation of

1 Staff's recommended rate of return is shown on page 15 of Exhibit No. \_\_\_\_ (DPK-2)  
2 on Schedule 4 for Avista's electric operations and on page 10 of Exhibit No. \_\_\_\_  
3 (DPK-3) on Schedule 4 for Avista's gas operations. The overall weighted cost of  
4 capital used in my analysis is 8.13%.

5  
6 **IV. DISCUSSION**  
7

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

10 A. I testify to Staff's recommended revenue requirement for Avista's Washington's  
11 electric and gas operations, as shown on page 1 of Exhibit No. \_\_\_\_ (DPK-2),  
12 Electric- Results of Operations, and Exhibit No. \_\_\_\_ (DPK-3), Gas-Results of  
13 Operations. These exhibits show actual and pro forma results of operations together  
14 with the impact of Staff's recommended revenue requirement for Avista's electric  
15 and gas operations, with additional supporting schedules. Along with my  
16 recommended adjustments, I have incorporated adjustments from other Staff  
17 witnesses into the exhibits.

18 **Q. In addition to incorporating the adjustments and analyses of other witnesses**  
19 **testifying on behalf of Commission Staff, what specific adjustments are you**  
20 **responsible for?**

21 A. Of the 42 Company proposed adjustments, I am responsible for the following 20  
22 restating adjustments:  
23

- Deferred Federal Income Tax
- Colstrip 3 AFUDC Elimination
- Kettle Falls Disallow
- Depreciation True-up
- Eliminate B & O Taxes
- Uncollectable Expense
- Injuries and Damages
- Eliminate WA Power Cost Defer
- Eliminate A/R Expenses
- Restate Excise Taxes
- Restate Debt Interest
- Deferred Gain on Office Building
- Nez Perce Settlement Adjustment
- Customer Advances
- Settlement Exchange Power
- Property Tax
- Regulatory Expense
- Federal Income Tax
- Office Space Charges to Subsidiaries
- Net Gains/losses

1

2

I am also responsible for the following 12 pro forma adjustments.

- Production Property Adjustment
- Capital Additions 2008
- Capital Additions Noxon
- Information Services
- CDA Tribe Settlements
- O&M Plant Expense
- Transmission Rev/Exp
- Capital Additions 2009
- Asset Management
- Spokane River Relicensing
- Montana Lease
- Clark Fork PM&E

3

4

5 **Q. Please give a brief overview of your Exhibit No. \_\_\_\_ (DPK-2), entitled “Avista**  
 6 **Corporation, Electric – Results of Operations, Twelve Months ended**  
 7 **September 30, 2008.”**

1 A. Exhibit No. \_\_\_\_ (DPK-2) is a 15-page exhibit showing the Staff analysis of the  
2 Company's results of operations for the test year. Page one of Exhibit No. \_\_\_\_  
3 (DPK-2), labeled Schedule 1.1, presents the Results of Operations, Rate Base, and  
4 Return on Investment (ROI). The Company's Unadjusted Results are shown in  
5 Column (b), Restated Results are shown in Column (d), and Pro forma Results are  
6 shown in Column (f) with pro forma test year results adjusted for Staff proposed  
7 revenues shown in Column (h).

8 Further, the restating amounts shown in Column (c) are itemized on pages  
9 two to seven of Exhibit No. \_\_\_\_ (DPK-2), labeled as schedule 1.2, using the same  
10 adjustment titles as the Company uses in Elizabeth Andrews's Exhibit No. \_\_\_\_  
11 (EMA-2). However, for ease of reference and to avoid possible confusion, Staff has  
12 added restating adjustment numbers to the Company's restating adjustment titles. In  
13 addition to the Company's adjustments, Schedules 1.2 reflects added adjustment  
14 numbers and titles for Staff's proposed restating adjustments.

15 Pro forma amounts shown in Column (e) are itemized on pages eight to  
16 eleven of Exhibit No. \_\_\_\_ (DPK-2), labeled Schedule 1.3.

17

18 **Q. Please explain more fully the columns shown on page one of your Exhibit No.**  
19 **\_\_\_\_ (DPK-2).**

20 A. Page one of Exhibit No. \_\_\_\_ (DPK-2), Electric – Results of Operations (Schedule  
21 1.1), has eight columns. Column (a), titled “Description,” contains the account  
22 descriptions.



1 A. As defined in WAC 480-09-330(2)(b)(i), restating actual adjustments (restating  
2 adjustments) are those “adjustments which adjust the booked operating results for  
3 any defects or infirmities which may exist in actual recorded results which can  
4 distort test period earnings. Restating actual adjustments are also used to adjust from  
5 an as recorded basis to a basis which is acceptable for ratemaking.”

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

9

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

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

20

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

22 A. Avista’s use of column letters instead of adjustment labels has a potential of causing  
23 confusion when citing restating adjustments. Although Staff routinely adopts the

1 Company's labeling convention, Staff in this case has retained the title of the  
2 Company's restating adjustment but labeled the adjustments using the common  
3 labeling convention of "R-#" for Restating Adjustment with the appropriate number,  
4 for example R-1 for Deferred FIT Rate Base. My Exhibit No. \_\_\_\_ (DPK-2) page 12,  
5 and Exhibit No. \_\_\_\_ (DPK-3) page 7, Summary of Adjustments - Schedule 4,  
6 provides both the Company's column label and Staff's Restating Adjustment label in  
7 Column (a).

## 8 9 V. ADJUSTMENTS

10  
11 **Q. Ms. Andrews provided summary schedules of the Company's adjustments in**  
12 **her Exhibit No. \_\_\_\_ (EMA -2) for its electric operations and Exhibit No. \_\_\_\_**  
13 **(EMA -3) for its natural gas operations. Does Staff accept any of the**  
14 **Company's proposed adjustments?**

15 A. Yes. Staff accepts many of Avista's proposed adjustments. In my Summary of  
16 Adjustments - Electric Operations (Schedule 1.4), found in Exhibit No. \_\_\_\_ (DPK-  
17 2), page 12, and Summary of Adjustments - Gas Operations, found in Exhibit No.  
18 \_\_\_\_ (DPK-3), page seven, contested adjustments are indicated with the letter "C" in  
19 column (a). All other adjustments not labeled were examined by Staff who  
20 conducted discovery, and concluded that each of the adjustments not marked with a  
21 "C" (contested) is reasonable in principle and calculation and, where applicable,  
22 consistent with prior Commission orders.

1                   The following tables reflect the uncontested adjustments for Avista's  
2                   Washington operations:

3                   Table 1 – Uncontested Adjustments — Electric Operations

4

R-1 (c)	Deferred FIT Rate Base	R-16 (r)	Nez Perce Settlement Adjustment
R-2 (d)	Deferred Gain on Office Building	R-17 (s)	Eliminate A/R Expenses
R-3 (e)	Colstrip 3 AFUDC Elimination	R-18 (t)	Office Space Charges to Subsidiaries
R-4 (f)	Colstrip Common AFUDC	R-19 (u)	Restate Excise Taxes
R-5 (g)	Kettle Falls Disallow	R-20 (v)	Net Gains/losses
R-6 (h)	Customer Advances	R-21 (w)	Revenue Normalization
R-7 (i)	Depreciation True-up	R-23 (y)	Restate Debt Interest
R-8 (j)	Settlement Exchange Power	PF-5	Transmission Rev/Exp
R-9 (k)	Eliminate B & O Taxes	PF-11	Spokane River Relicensing
R-11 (m)	Uncollectible Expense	PF-12	CDA Tribe Settlement
R-12 (n)	Regulatory Expense	PF-13	Montana Lease
R-13 (o)	Injuries and Damages	PF-17	Employee Benefits
R-14 (p)	Federal Income Tax	PF-19	Clark Fork PM&E
R-15 (q)	Eliminate WA Power Cost Defer		

5

6                   Table 2 – Uncontested Adjustments — Gas Operations

R-1 (c)	Deferred FIT – Rate Base	R-10 (l)	Uncollectible. Expense
R-2 (d)	Deferred Gain on Office Building	R-11 (m)	Regulatory Expense
R-3 (e)	Gas Inventory	R-12 (n)	Injuries and Damages
R-4 (f)	Weatherization and DSM Investment	R-13 (o)	Federal Income Tax
R-5 (g)	Customer Advances	R-14 (p)	Net Gains/Losses
R-6 (h)	Depreciation True-up	R-15 (q)	Eliminate A/R Expenses
R-7 (i)	Revenue Normalization & Gas Cost	R-16 (r)	Office Space Charges to Subsidiaries
R-8 (i)	Eliminate B & O Taxes	R-17 (s)	Restate Excise Tax

R-18 (t)	Misc Restating Adjustments	PF-3	JP Storage
R-19 (u)	Restate Debt Interest	PF-9	Employee Benefits

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**VI. UNCONTESTED ADJUSTMENTS**

**A. Deferred Gain on Office Building — P-2 (Electric and Gas)**

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

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

**B. Deferred FIT Rate Base — R-1 (Electric and Gas)**

**Q. Although the pro forma adjustment to include the effect of Deferred Federal Income Tax (Deferred FIT) in Rate base was also uncontested, would you please discuss the regulatory issue related to the Commission’s handling of Deferred FIT in rate base**

1 as shown in column (c), line 55 of page 2 in Exhibit \_\_\_\_ (DPK- 2) and column (c),  
2 line 60 of page 2 in Exhibit \_\_\_\_ (DPK-3)?

3 A. Restating adjustment R-1 is a Company-proposed adjustment that reflects the effect of  
4 income tax timing differences between regulatory basis and tax basis accounting for both  
5 its electric operations and its natural gas operations. Although the Company did provide  
6 minimal direct testimony on this adjustment, it did not support its proposal to use the  
7 average-of-monthly-average Deferred FIT balance as the basis for the test year  
8 accumulated deferred income tax deduction from rate base, rather than the end-of-period  
9 deferred income tax balance. *See* Ms. Andrews's direct testimony, Exhibit \_\_\_\_ (EMA-  
10 1T) at 13:11-17 and 39:1-7.

11  
12 **Q. Does this difference reflect a change in the usual approach required by the**  
13 **Commission?**

14 A. Yes, this is a change in method. It has been the Commission policy since the late 1970s  
15 to use end-of-period accumulated deferred income tax balance for the rate base  
16 deduction, even though average-of-monthly-averages were used for all other rate base  
17 components.<sup>1</sup> It has been the Commission position that the use of the end-of-period  
18 balance deferred tax amount while using a historical average-of-monthly-averages for all  
19 other items in rate base was specifically allowed by the Internal Revenue Service  
20 regulations.<sup>2</sup>

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<sup>1</sup> *Utilities & Transp. Comm'n v. General Telephone Company of the Northwest, Inc.*, Cause U-80-38, Third Supplemental Order (1981TK date) at 7.

<sup>2</sup> Internal Revenue Service 26 CFR 1.167(l)-1(h)(6) Exclusion of Normalization Reserve from Rate Base.

1           Discussions with the Company confirm that Avista filed its case using average  
2 accumulated deferred tax balance as its deduction for rate base, so it would be in  
3 compliance with a recently issued IRS Private Letter Ruling (PLR).  
4

5 **Q. Please identify and then briefly discuss the Private Letter Ruling the Company**  
6 **relied on in its filing.**

7 A. In June 2008, the Internal Revenue Service issued a PLR (PLR 200824001) that  
8 determined that the regulatory use of an average rate base with an end-of-period deferred  
9 tax reserve component was a violation of IRS normalization requirements. The Private  
10 Letter Ruling had been requested by Puget Sound Energy with the knowledge of Staff.  
11 Puget Sound Energy had filed the request for a private letter ruling on October 26, 2006.  
12 Although the utility and the state are redacted from the published PLR, the Private Letter  
13 Ruling request directly addressed the Washington Commission's rate base methodology:  
14 the Commission's practice of using average-of-monthly-averages (AMA) for all rate base  
15 components except for accumulated deferred income taxes which were recognized at test-  
16 year ending balance amounts.

17  
18 **Q. Is it your opinion that the Company filing is consistent with the ruling by the IRS?**

19 A. Although a private letter ruling cannot be used or cited as precedent except by the party  
20 to whom it was issued (e.g., Puget Sound Energy), it can be used as guidance on possible  
21 actions by the IRS against companies with similar normalization issues.<sup>3</sup> After reviewing

---

<sup>3</sup> The IRS can revoke or modify a private letter ruling by, among other methods, issuing a revenue ruling or procedure, or by regulations. See Section 11 of the IRS Revenue Procedure 2005-1.

1 the private letter ruling, Staff believes Avista's concerns are legitimate, that the use of  
2 year-end accumulated deferred taxes with an AMA rate base would be found to be a  
3 violation of normalization. Therefore, Staff agrees with the Company in its use of an  
4 AMA deferred tax consistent with an AMA rate base.

## 6 VII. CONTESTED ADJUSTMENTS

### 8 A. Property Tax Adjustment — R-10 (l) Electric and R-9 (k) Gas

#### 10 Q. Please summarize the Company's adjustments to Property taxes.

11 A. The Company's adjustments increase property taxes for its electric operations and reduce  
12 property taxes for its gas operations. The Company's adjustment uses projected tax rates  
13 and assessment factors as well as recognizing the increase in property taxes for the  
14 inclusion of the Company's Coyote Springs plant located in Oregon. The Coyote Springs  
15 plant had been previously excluded from the Company's tax base as a result of its being  
16 located in the Columbia River Enterprise Zone. However, the plant is no longer protected  
17 from taxation and the Company's proposed adjustment includes the related increased  
18 property taxes.

19 Staff agrees with the pro forma adjustment, except that the Company has used  
20 projected normalization factors along with projected tax rates. Staff, in its proposed

1 adjustments, uses the historical rates and factors reflected in the Company's latest tax  
2 assessments.

3  
4 **Q. What are the effects of your adjustments?**

5 A. Staff's proposed adjustments increase property tax expense for Washington electric  
6 operations by \$196,000, whereas Staff proposes a decrease in property tax for Avista's  
7 Washington gas operations of \$748,000. (R-10 Electric and R-9 Gas, respectively)  
8 These adjustments decrease net income after taxes by \$127,000 for the Company's  
9 electric operations and increases net income after taxes by \$486,000 for its gas  
10 operations. This results in an increase in revenue requirement of \$205,000 for  
11 Washington's electric operations and a decrease of \$781,000 in revenue requirement for  
12 its gas operations.

13  
14 **B. Customer Deposits Adjustment — R-24 Electric and R-20 Gas**

15  
16 **Q. Please discuss your adjustments to the Company's results of operations for  
17 customer deposits.**

18 A. These adjustments reduce the Washington jurisdictional rate base for electric and gas  
19 operations by the average of monthly average balance of customer deposits. In addition  
20 to a rate base reduction by the amount of customer deposits, these adjustments treat the  
21 test year associated interest expense as an above-the-line item for ratemaking purposes.  
22 The effect of the rate base reduction is to recognize that a portion of rate base is funded  
23 by the customer deposits, which cost less than the Company's overall cost of capital. The

1 operating expense treatment of the interest paid by the Company recognizes the actual  
2 cost associated with such deposits, which will be borne by the general body of customers  
3 that benefit from the rate base reduction.  
4

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

6 A. The interest rate for 2009 is 0.42 percent.  
7

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

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

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

17 A. The Commission should accept Staff's adjustment because it is fair to both the customers  
18 and the Company. On one hand, customers get credited for the cheaper funds available  
19 for the Company's use, and the direct rate base deduction ensures that the customer-  
20 provided funds do not benefit non-utility operations. On the other hand, the Company  
21 remains whole by inclusion of the actual interest paid on deposits as an operating  
22 expense.  
23

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

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

11

12 **Q. What is the impact of Staff's adjustment for customer deposits?**

13 A. The adjustment affects both electric and gas Washington jurisdictional results of  
14 operations. In the electric results of operations, the adjustment reduces the Washington  
15 electric rate base by \$1,334,976 and the Washington electric net operating income by  
16 \$5,607, for a net decrease in revenue requirement of approximately \$180,000. In the gas  
17 results of operations, the adjustment reduces the Washington gas rate base by \$830,137  
18 and the Washington gas net operating income by \$3,487, for a net decrease in revenue  
19 requirement of approximately \$112,000.

20

1 **C. Board of Directors Meetings Adjustment — R-25 Electric and R-21 Gas**

2

3 **Q. Please discuss your adjustment to the Company's results of operations for Board of**  
4 **Directors Meetings.**

5 A. Staff proposes that Board of Director meeting costs be shared by shareholders. The  
6 Company's Board of Directors meetings serve not only ratepayers, but since Avista's  
7 Board of Directors are elected by shareholders with the purpose to oversee and enhance  
8 the corporate value of Avista, they obviously serve shareholder interests as well. Staff  
9 recognizes that Board of Director meetings are a necessary cost of doing business, but  
10 Staff would argue that meetings clearly provide benefits to both ratepayers and  
11 shareholders. Although Staff believes that ratepayers should bear some of the cost of the  
12 Board meetings, shareholders also benefit from the meetings and should bear a  
13 reasonable share of the costs. Staff believes a 50% sharing of meeting costs is reasonable.

14

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

16 A. The adjustment affects both electric and gas Washington jurisdictional results. Staff  
17 proposed adjustment reduces electric operations total expenses by \$45,229 or \$29,000  
18 after income tax, resulting in a \$47,000 decrease in revenue requirement. For Avista's  
19 gas operations, total expense are reduced by \$12,501 or \$8,000 after income tax, resulting  
20 in a \$13,000 decrease in gas revenue requirement.

21

1 **D. Restate Debt Interest — R-23 (y) Electric R-19 (u) Gas**

2

3 **Q. Please describe the Restatement of Debt Interest adjustment.**

4 A. The debt interest adjustment, also referred to as interest synchronization or pro forma  
5 interest adjustment, adjusts the book interest expense to the amount reflected by the  
6 application of the weighted cost of debt to the pro forma rate base. The purpose of this  
7 adjustment is to synchronize the effect of interest expense on the computation of income  
8 taxes used for setting rates to rate base. The weighted cost of debt is applied to rate base  
9 to derive a pro forma interest expense. The derived amount is then used as a component  
10 in the computation of the regulatory income tax.

11

12 **Q. Have you prepared any schedules reflecting your calculation of your Restatement  
13 of Interest Adjustment?**

14 A. Yes. I have prepared two exhibits. One for Avista's electric operations, Exhibit  
15 No.\_\_(DPK-4) and one for its gas operations, Exhibit No.\_\_(DPK-5). Both are labeled  
16 "Pro Forma Interest Adjustment" with the appropriate adjustment number.

17

18 **Q. Are Staff's proposed adjustments consistent with prior Commission decisions?**

19 A. Yes. However, both the Company's adjustments and Staff's do not include a deduction  
20 from rate base of Construction Work In Progress (CWIP), which the Commission has  
21 traditionally included in the pro forma interest adjustment.

22

1 **Q. Could you briefly discuss why CWIP ordinarily is included in the pro forma interest**  
2 **adjustment?**

3 A. Yes. Regulatory accounting normally requires the Company to capitalize into the total  
4 cost of its long-term construction projects the interest cost of the projects. The capitalized  
5 interest is recovered over the life of the related utility plant once it is placed in service.  
6 The regulatory capitalization of interest is referred to as Allowance for Funds Used  
7 During Construction (AFUDC) - Debt.

8 Under pre-1987 income tax law, the Company was not required to capitalize its  
9 interest costs related to self-constructed or self-produced assets, and therefore the  
10 Company was free to flow-through the interest cost in the year incurred for income tax  
11 purposes even though the same interest was capitalized and deferred for regulatory  
12 purposes. This resulted in a mismatch between the amounts actually paid in income taxes  
13 and the amount of income taxes calculated for rate setting purposes. The income tax  
14 actually incurred was less than the amount provided for by the pro forma debt  
15 computation because the interest deduction for tax purposes was greater than for  
16 regulatory purposes due to the flow-through of interest. In order to correct this mismatch,  
17 CWIP was added to the pro forma debt computation accounting for the effect of the  
18 flowed-through interest.

19  
20 **Q. Currently, for income tax purposes, is the Company still allowed to flow-through**  
21 **interest related to long-term projects?**

22 A. No, it is not. The Company is now required under Section 263A of the Internal Revenue  
23 Code to capitalize the interest costs related to its long-term construction projects. Though

1 there are some exceptions, such as construction related to Research and Development and  
2 other intangibles, in general, the Company must capitalize not only its direct interest  
3 costs, but also its indirect interest costs.  
4

5 **Q Please describe the effect of Section 263A on the inclusion of CWIP in the pro forma**  
6 **interest computation.**

7 A. Now that the Company must capitalize its interest costs, there is little or no tax benefit  
8 which can flow-through to the ratepayer and therefore, there is no requirement to include  
9 263A eligible CWIP in the computation.  
10

11 **Q. Is the amount of interest capitalized under Section 263A equivalent to the interest**  
12 **capitalized under the regulatory AFUDC-Debt method?**

13 A. No, it is not. Typically, more interest is required to be capitalized under Section 236A  
14 than is capitalized under the regulatory AFUDC – Debt approach. Although not material  
15 in amount, the Internal Revenue Code normally requires the Company to capitalize a  
16 larger amount of its incurred interest costs than the Company would under AFUDC,  
17 therefore making the purpose of including CWIP in the pro forma interest adjustment  
18 moot.  
19

20 **Q. Do you propose to include all CWIP in the pro forma debt computation?**

21 A. No, only non-263A CWIP should continue to be added to the pro forma interest  
22 computation to recognize the Company's ability to flow-through the interest for those  
23 projects to interest expense for income taxes.

1 **Q. Please describe your proposed pro forma interest adjustment and the difference**  
2 **between the Staff recommendation and the Company’s proposal.**

3 A. Staff proposed adjustment reduces income tax expense by \$1,045,000 for Avista’s  
4 electric operations and \$134,000 for its gas operations as shown on Exhibit \_\_\_\_ (DPK-4)  
5 and Exhibit \_\_\_\_ (DPK-5) respectively. The Company’s revenue requirement for its  
6 electric operations decreases by \$1,680,000, and \$215,000 for its gas operations. The  
7 differences between the Staff’s proposals and the Company’s are due solely to Staff’s use  
8 of the weighted cost of debt recommended by Staff witness Mr. Parcell, and the use of  
9 Staff’s recommended electric and gas rate bases.

10

11 **E. Pro forma Production Property Adjustment — PF 2 (Electric)**

12

13 **Q. Please discuss the Production Property Adjustment and describe the purpose of the**  
14 **adjustment.**

15 A. This adjustment reflects the application of a production factor to complete the pro  
16 forming of production costs from the forward looking “rate year” level (January 2010 to  
17 December 2010) back to the historic “test year” (October 2007 to September 2008)  
18 amount. The adjustment is a necessary component when pro forma major production  
19 plant additions from outside the test year are included in rate base and the results of  
20 operations. The production property adjustment allows the matching of the relationship  
21 between future sales (measured by increased system load) to the production rate base.

22 The production factor is the ratio of test-period loads and the 2010 pro forma rate  
23 year loads. In the determination of net power costs, rate year levels of consumption are

1 used. Likewise, the adjustment considers the associated power costs for the future rate  
2 year. Central to the adjustment is the assumption that the future rate year will have  
3 different levels of consumption than the normalized historic test period. The factor is  
4 derived by taking future loads over test year normalized loads. The resulting production  
5 factor is then applied to the rate year production costs, bringing the pro formed rate year  
6 costs, on a unit basis, back to the historic test year for proper matching and comparability  
7 of all costs used in the revenue requirement determination.

8 Production costs that are subject to the production factor are dependent on other  
9 power- related ratemaking adjustments. This adjustment is a fallout adjustment that is  
10 dependent on rate year power costs and related expenses and production rate base levels,  
11 which may be different from the final cost inputs determined by the Commission.

12 Therefore, if power supply costs are recomputed, as with any other production associated  
13 adjustments, the production property adjustment must be recomputed. I have provided an  
14 exhibit detailing the computation of the adjustment in my exhibit labeled Exhibit No. \_\_\_\_  
15 (DPK-5).

16  
17 **Q. Please describe your calculation of the Production Property Adjustment.**

18 A. I start with the Company's "actual per results report" amounts for production expenses  
19 and production related rate base components shown in column (b) of Ms. Andrews's  
20 Electric Results of Operations exhibit (Exhibit No. \_\_\_\_ (EMA-2) page 1 of 11). From  
21 those amounts, I add or subtract the various restating and pro forma adjustments related  
22 to production as shown lines 2 through 48 of my Exhibit No. \_\_\_\_ (DPK-5). The resulting

1 amounts shown on line 50 represents the adjusted production and rate base amounts for  
2 the test year.

3 The test year adjusted production amounts are then adjusted by the production  
4 factor (discussed above) providing the amount of expense to be embedded in rates, while  
5 still accounting for expected rate year load.

6

7 **Q. Does your Production Property Adjustment take into account Mr. Buckley's**  
8 **recommendation that the rate year load factor be reduced by 3% from the**  
9 **Company's proposal?**

10 A. Yes. The load factor for the 2010 Washington retail load shown on Exhibit \_\_\_(DPK-5)  
11 line 52 has been reduced from the Company's proposal by three percent. As discussed by  
12 Mr. Buckley, the reduction reduces Avista's expected load growth from a 5 percent  
13 growth to a more conservative 2 percent level.

14

15 **Q. What is the impact of Staff's Production Property Adjustment?**

16 A. The Production Property adjustment affects only the electric operations of Avista. Staff's  
17 proposed adjustment increases net operating income by \$3,077,000 while reducing rate  
18 base by \$7,113,000. The combined effect reduces revenue requirement by \$5,940,000.

19

20 **Q. Did you review the Company's proposed Production Property Adjustment?**

21 A. Yes.

22

1 **Q. Is the Company proposed adjustment consistent with the purpose of the Production**  
2 **Property Adjustment you described above?**

3 A. No. The Production Property adjustment proposed by the Company fails to match  
4 properly pro forma plant additions and production related expenses with the test year,  
5 recognizing future load. In addition, the Company's adjustment does not include  
6 production related test year expenses or assets, but instead the Company's calculation  
7 uses only pro forma plant and expense adjustments.

8 In addition, the Company proposes using two load factors. One load factor is for  
9 the pro forma year (the year following the test year) and another load factor is for the rate  
10 year. The splitting of pro forma additions between two factors does not provide a  
11 matching of costs with rate year loads when rates will be in effect. The Production  
12 Property methodology proposed by the Company should be rejected since it fails to  
13 recognize test year production rate base and expenses and fails to match selected pro  
14 forma adjustments to the rate year load.

15  
16 **F. Capital Additions**

17  
18 **Q. Please discuss the Company's adjustments for Capital Additions.**

19 A. In its proposed capital additions adjustments, the Company initially pro forms an  
20 adjustment (PF-6 electric and PF4 gas) to its electric and gas plant-in-service amounts.<sup>4</sup>

21 These initial capital additions adjustments adjust rate base in two ways: (1) pro forms

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<sup>4</sup> PF-6 Electric, PF4 Gas.

1 additional plant- in- service three months outside the September 30, 2008, test-year end  
2 and (2) annualizes plant-in-service balances to a December 31, 2008, end-of-period  
3 balance. The remaining three capital additions adjustments for electric and gas operations  
4 recognize post test-year plant additions for 2009 and for the electric operations, 2010.<sup>5</sup>  
5 The proposed adjustments add an additional \$148 million of plant to the Company's  
6 electric rate base and \$12.8 million to its gas rate base. These adjustments represent a  
7 9.2% increase in total plant in service for the electric rate base and a 4.7% increase in  
8 total plant in service for the gas rate base.

9  
10 **Q. Does the Company identify specific projects for their proposed pro forma additions**  
11 **to rate base?**

12 A. Yes, Mr. Dave DeFelice lists over 70 projects for its 2009 capital additions pro forma  
13 adjustment.<sup>6</sup> In Mr. DeFelice's supporting work papers, he lists over 230 individual  
14 projects for support of his proposed 2009 adjustment.<sup>7</sup> In addition, Mr. Scott Kinney  
15 also lists \$9.18 million of specific projects in his testimony.

16  
17 **Q. Please briefly discuss your understanding of the regulatory principle supporting the**  
18 **Company's pro forma adjustments.**

---

<sup>5</sup> PF-7 and PF-8 Electric, PF-5 Gas.

<sup>6</sup> *Id.*, pages 10-17.

<sup>7</sup> Workpapers of Dave. B. DeFelice, pages 43-54.

1 A. In support of its adjustments, Company witness Mr. DeFelice argues that the plant will  
2 be..."... 'known and measurable' prior to the time that rates go into effect..."<sup>8</sup>

3

4 **Q. Please describe your understanding of the Company's purpose in proposing the pro**  
5 **forma post test-year adjustments.**

6 A. The Company's position is that the adjustments are required because capital costs are  
7 growing faster than recovery through embedded depreciation expense.<sup>9</sup> This type of  
8 dynamic is often the result of an aggressive infrastructure growth and/or replacement  
9 program. In addition, both Mr. Mark Thies and Mr. William Avera discuss the negative  
10 effects of regulatory lag and the risk of the failure to recover capital investment. Mr.  
11 Thies states that investors and rating agencies are concerned about regulatory lag and cost  
12 recovery related to these items.<sup>10</sup> Mr. William Avera states in his filed testimony, "Of  
13 particular concern to investors is the impact of regulatory lag and cost-recovery on  
14 Avista's ability to earn its authorized ROE and maintain its financial metrics..."<sup>11</sup>

15

16 **Q. Is there a regulatory term for this kind of erosion of investment?**

17 A. Yes, regulation uses the term attrition. Attrition is the tendency of a utility's rate of  
18 return to diminish over time, either because of inflationary pressures or when capital  
19 investment is not in balance with capital recovery.

20

---

<sup>8</sup> Testimony of Dave B. DeFelice, Exhibit No. \_\_\_\_ (DBD-1T), page 2, lines 14-15.

<sup>9</sup> *Id.*, page 7, lines 4-6.

<sup>10</sup> Testimony of Mark Thies, Exhibit No. \_\_\_\_ (MTT-1T), page 21, lines 5-6.

1 **Q. Did you review prior Commission decisions to aid you in your review of the**  
2 **Company’s proposed adjustments?**

3 A. Yes. Staff took note of prior Commission orders for guidance in its review of Avista’s  
4 proposal. For example, in a recent Puget Sound Energy decision, the Commission  
5 discussed attrition in the context of capital investment. In that order the Commission  
6 clearly states that extraordinary circumstances are required to depart from fundamental  
7 ratemaking principles.<sup>12</sup> In addition, in the same order, the Commission denies out-of-  
8 period adjustments since there was “scant basis upon which to determine ... to what  
9 extent they may be used and useful.”<sup>13</sup> Finally, in a 2005 Avista order, regarding the pro  
10 forma addition to rate base of an adjustment entitled “Rate Base Adjustment for Coyote  
11 Springs II,” the Commission stated:

12 The matching principle requires that all cost-of-service  
13 components – revenue, investment, expenses and cost of  
14 capital – must be considered and evaluated at a similar point  
15 in time.<sup>14</sup>

16  
17 These Commission decisions support the Staff recommendations regarding pro forma  
18 capital additions set forth below.

19  
20 **1. Capital Additions 2008 — PF-6 Electric and PF-4 Gas**

21  
22 **Q. Please discuss the Company’s adjustment for 2008 Capital Additions.**

---

<sup>11</sup> Testimony of William E. Avera, Exhibit No. \_\_\_ (WEA-1T), page 47, lines 20-21.

<sup>12</sup> *WUTC v. Puget Sound Energy, Inc.*, Docket UE-060266, 255 PUR4<sup>th</sup> 287, (2007), Order 08 at 18.

<sup>13</sup> *Id.* at 19.

<sup>14</sup> *WUTC v. Avista Corp.*, Dockets UE-050482, Order 5 at 111.

1 A. The Company's pro forma adjustments propose two major adjustments. The Company  
2 (a) abandons the average-of-monthly-average for end-of-period and (b) moves the end of  
3 the test-year plant in service to a pro forma amount as of December 31, 2008, three  
4 months after the end of the actual end-of-period.

5  
6 **Q. What offsetting factors are included in the Company's proposed adjustment?**

7 A. Other than recognizing the impact on depreciation expense, deferred taxes, and property  
8 taxes, the Company has not included any offsetting factors. To properly match any  
9 revenues that may be provided in rates, a pro forma adjustment must not only identify the  
10 additional capital costs to provide service associated with the additional pro forma plant,  
11 but it must also identify and measure all offsetting factors, including any benefit or cost  
12 savings. Although the Company's proposed adjustments recognize increased costs such  
13 as depreciation and return on investment, it makes no attempt to quantify or even address  
14 possible cost savings. There is notable absence in the testimony of any discussion  
15 regarding studies of cost savings or other benefits associated with this adjustment.  
16 Without a thorough understanding of all offsetting benefits, there can be no matching of  
17 revenues with costs.

18  
19 **Q. Is the adjustment proposed by the Company consistent with prior ratemaking  
20 practice in the State of Washington?**

21 A. No. The proposed adjustment departs from the average-of-monthly-averages method  
22 consistently used by the Commission to measure rate base. Only rarely in prior cases has  
23 the Commission used end-of-period rate base, and it is clearly the exception. For

1 example, in the past the Commission has allowed the end-of-period approach to  
2 compensate for periods of high economic inflation<sup>15</sup> and in circumstances that involve  
3 rapid growth in infrastructure.<sup>16</sup> Consistent with each prior Commission decision was the  
4 reiteration of the matching principle when addressing end-of-period rate base, where  
5 revenues, expenses and customer count must be considered in matching costs and  
6 benefits with additional plant.<sup>17</sup> Here, Avista has failed to match revenues or costs to its  
7 proposed period end. Furthermore, the Commission has never approved an end-of-period  
8 test year that concludes three months after the end of the actual test-year results.  
9

10 **Q. Should the Commission accept the Company proposed adjustments PF-6 (Electric)**  
11 **and PF-4 (Gas), changing rate base valuation to end-of-period?**

12 A. No. A proper pro forma adjustment must, by necessity, consider all material impacts and  
13 offsetting factors. If the adjustment does not, the adjustment should be rejected. The  
14 Company's proposed adjustments, which depart from the average-of-monthly-averages  
15 method of valuing rate base, simply provides for a wholesale inclusion of all plant in  
16 service and is clearly not supported. Other than depreciation, the Company did not address  
17 the corresponding changes in customer count, expenses, and revenues. PF-6 (Electric)  
18 and PF-4 (Gas) should be rejected.  
19

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<sup>15</sup> *WUTC v. Washington Natural Gas. Co.*, Cause No. U-80-111, Third Supplemental Order (September 1981)

<sup>16</sup> *WUTC v. Puget Sound Power and Light Company*, U-73-57, 6<sup>th</sup> Supplemental Order (October 1974)

<sup>17</sup> *WUTC v. American Water Resources, Inc.*, Dockets UW-980072 UW-980258, et al., consolidated (November 1998) at 18

1           **2.       Capital Additions 2009 — PF-7 Electric and PF-5 Gas**

2  
3   **Q.       Please discuss the Company's adjustment for 2009 Capital Additions.**

4   A.       The Company's pro forma adjustments pro form in the capital cost and expense of  
5           projects expected to be completed by December 31, 2009. The Company then calculates  
6           the pro forma balance of 2008 plant in service to December 31, 2009, levels, including  
7           accumulated depreciation and deferred FIT. In addition, the pro forma adjustment  
8           recognizes both pro forma depreciation expense and property tax.

9  
10 **Q.       What offsetting factors are included in the Company's proposed adjustments?**

11 A.       As with the Company's adjustment for 2008 capital additions, other than recognizing the  
12           impact on depreciation expense, deferred taxes, and property taxes, the Company has not  
13           included any offsetting factors. To properly match any revenues that may be provided in  
14           rates, a pro forma adjustment must not only identify the additional capital costs to  
15           provide service associated with the additional pro forma plant, but it must also identify  
16           and measure all offsetting factors, including any benefit or cost savings. Although the  
17           Company's proposed adjustments recognize increased costs such as depreciation and  
18           return on investment, the Company makes no attempt to quantify or even address  
19           possible cost savings.

20  
21 **Q.       Are all 2009 capital projects included in the Company's proposed out-of-period pro**  
22 **forma adjustment?**

1 A. No. Mr. DeFelice describes in his testimony that the pro forma adjustments do not  
2 include “revenue producing projects.” However, again, as with the 2008 Capital  
3 Addition testimony, there is no discussion regarding studies of cost savings or other  
4 benefits associated with this adjustment. The Company has produced Internal Rates of  
5 Return (IRR) studies that indicate that many of the projects will produce a reduction of  
6 the increase in future costs. However, the decrease in the future increase in costs is not  
7 quantified in the Company’s proposed adjustment. Without a thorough understanding of  
8 all offsetting benefits, allowing benefits to be quantified for ratemaking, there can be no  
9 true matching of revenues with costs.

10

11 **Q. Are these adjustments proposed by the Company consistent with prior ratemaking**  
12 **practice in the State of Washington?**

13 A. No. The proposed adjustments are not consistent with prior practice of the Commission.

14

15 **Q. Please describe how the proposed adjustments vary from the prior practice.**

16 A. The proposed adjustments are not consistent with prior orders in two aspects. First, the  
17 adjustment includes 2008 vintage plant pro formed to an end of period December 31,  
18 2009, adjusted balance, including accumulated depreciation and deferred FIT. This  
19 technique has never been used by the Commission for the computation of pro forma plant  
20 and Staff believes it should be rejected. The use of the AMA test year requires test year  
21 plant to be weighted by the average of monthly average approach. Moving 2008 vintage  
22 plant-in-service forward one year to end-of-period adjusted balances simply skews the

1 test year plant-in-service balances and creates a definite mismatch of revenues and  
2 expenses of the test year.

3 Second, the adjustment is not consistent with the prior practice of the Commission  
4 because of the Company's inclusion of budgeted capital additions for 2009. Staff is not  
5 aware of the Commission ever accepting such a broad adjustment for out-of-period plant  
6 additions. Avista's pro forma of 2009 budgeted utility plant that was not used in the test  
7 period both violates the matching principle, is not known and measurable, and creates a  
8 mismatch of revenues, expenses, and services.

9  
10 **Q. Should the Commission accept the Company proposed adjustments PF-7 (Electric)**  
11 **and PF-5 (Gas)?**

12 A. No. As with the prior Capital Addition pro forma adjustments, a pro forma adjustment  
13 must, by necessity, consider all material impacts and off-setting factors. If a proposed  
14 adjustment does not, the adjustment should be rejected. The Company's proposed  
15 adjustments improperly pro form 2008 vintage plant to a point in time 15 months past the  
16 end of the test year. The Company then proposes the amounts be included in rate base at  
17 an end-of-period basis, completely abandoning average-of-monthly-average rate base  
18 valuation.

19 In addition, the use of a capital budget to pro form in plant into the rate base, even  
20 with the exclusion of revenue producing plant, violates the known and measurable  
21 standard. Furthermore, offsetting factors and costs, other than depreciation and property  
22 taxes, have not been recognized. The Company's adjustment, therefore, should be  
23 rejected.

1 **Q. Although Staff is recommending rejection of the Company’s proposed pro forma**  
2 **adjustments for its 2009 Capital Additions, does Staff have a proposal that is**  
3 **consistent with Commission decisions and ratemaking practice?**

4 A. Yes. Staff is proposing adjustment PF-7 (Electric) for Avista’s 2009 capital additions.  
5 Staff, however is not proposing any pro forma adjustment for Avista’s 2009 Gas  
6 operations additions.

7  
8 **Q. What criteria was used by Staff to develop its proposal for the inclusion of certain**  
9 **out-of-period plant in rate base?**

10 A. It must meet the standard of a pro forma adjustment set out in WAC 480-07-510(3)(iii).  
11 Any adjustment must “give effect for the test period to all known and measurable  
12 changes that are not offset by other factors.”<sup>18</sup> In addition, all plant additions are assumed  
13 to be beneficial in some way or the project would not be done. For example, an addition  
14 to distribution plant can be for reliability purposes but, because it is used for energy  
15 distribution, there is an assumption, absent clear auditable evidence, that the project has  
16 other offsetting factors such as less service calls or shorter outages which can increase  
17 revenues.

18  
19 **Q. Which out-of-period test-year plant projects not having offsetting factors, could be**  
20 **allowed for inclusion in rate base?**

---

<sup>18</sup> WAC 480-07-510(3)(iii).

1 A. Certain projects are required by laws, regulations, or directives from regulatory bodies.  
2 Required projects such as these do not necessarily have offsetting factors, other than  
3 depreciation expense and associated deferred tax benefits which can be captured in a  
4 proposed pro forma adjustment. In addition, as described in Mr. Parvinen's testimony,  
5 the Commission has allowed, on a limited basis, pro forma transmission investment  
6 related to reliability.

7  
8 **Q. For the adjustment to be consistent with Commission decisions, are there further**  
9 **requirements for including a post-test year utility plant into rate base?**

10 A. Yes. 2009 plant that is proposed for inclusion in rate base must be adjusted to the test  
11 year, for otherwise there will be a mismatch of costs comparing test year ended  
12 September 2008 with 2009 plant. In order to match costs, the Commission has used the  
13 technique which adjusts the pro forma plant additions to the rate year adjusted balances.  
14 The plant is depreciated from its in-service date to the end of the rate year, which in this  
15 case is December 31, 2010. The matching occurs when the Production Property  
16 Adjustment (PF-2) is applied to the plant amounts adjusting the net plant, along with its  
17 associated expenses, by the ratio of test-year to rate-year load factors.

18  
19 **Q. Is your proposed 2009 Capital Additions adjustment consistent with the constraints**  
20 **you outlined above?**

21 A. Yes.

1 **Q. Is your proposed 2009 Capital Additions adjustment PF- 7 for Avista’s electric**  
2 **operations consistent with the pro forma constraints you outlined above?**

3 A. Yes.

4  
5 **Q. Please describe how you determined which 2009 Capital Additions to include in the**  
6 **proposed pro forma adjustment.**

7 A. The pro forma adjustment reflects post test-year capital additions from October 1, 2008,  
8 to June 30, 2009. The June 30, 2009, cutoff date was selected as the latest period that  
9 costs of completed projects were available for audit. Only projects that were in service,  
10 and therefore used and useful, as of June 30, 2009, were reviewed for possible inclusion  
11 in rate base.

12 Staff selected transmission projects that were either required by rule or regulatory  
13 requirements, or transmission projects that were completed for system reliability, for  
14 inclusion in rate base. In addition, two system distribution projects were included: wood  
15 pole replacement and Washington Department of Transportation required infrastructure  
16 relocations.

17 Generation and production projects were selected because in addition to the pro  
18 forma depreciation and deferred income tax explicit in the pro forma adjustment, the  
19 other cost benefits will be captured either in the Aurora system modeling or in Avista’s  
20 Energy Recovery Mechanism.

21 The above plant amounts were then adjusted to the rate year 2010 average of  
22 monthly averages balances, including computation of depreciation expense and related  
23 deferred taxes.

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

2 A. Staff proposed adjustment increases net rate base by \$21,252,000 and increases operating  
3 expenses by \$921,000, reducing net operating income after taxes by \$599,000. Including  
4 return on investment and increased expenses, the net effect of this adjustment increases  
5 revenue requirement by \$3,930,000, a reduction of revenue requirement of \$3,944,000  
6 from the Company's proposed \$7,874,000 in additional revenues.

7

8 **3. Capital Additions - Noxon — PF-8 (Electric)**

9

10 **Q. Please discuss the Company's adjustment for Noxon Generation 2010 (PF-8).**

11 A. The Company proposed Noxon Generation pro forma adjustment reflects the pro forma  
12 addition to rate base of the Noxon Unit #3 upgrade. The unit is expected to be in service  
13 (used and useful) in April of 2010. The Company has included the cost of the asset as a  
14 pro forma plant addition to be included in rate base.

15

16 **Q. What offsetting factors are included in the Company's proposed adjustments?**

17 A. The pro forma adjustment recognizes both pro forma depreciation expense and property  
18 tax along with the rate base effect of accumulated depreciation and deferred taxes.  
19 However, since Noxon #3 has been included as additional generation within the Aurora  
20 dispatch model, all material additional offsetting factors have been captured in the power  
21 supply adjustment.

22

23 **Q. Can budgeted post test-year plant additions be included in rate base?**

1 A. It is rare that plant that is not complete and used and useful will be included in rate base.  
2 However, the Commission has allowed inclusion in rate base of plant that will be used  
3 and useful during the rate year. There must be a reasonable expectation that the plant will  
4 be complete and the costs are prudent. It is Staff's opinion that the plant will be  
5 completed as scheduled and that the Noxon #3 upgrade was prudent.

6

7 **Q. Does Staff accept the Company adjustment for the Noxon #3 upgrade?**

8 A. Yes, with modifications. The Company had included in its 2009 pro forma adjustment  
9 (PF-7) the Noxon #1 upgrade which was completed April 2009. Since both Noxon #1  
10 and Noxon #3 are similar upgrade projects, both of which were included in the Aurora  
11 dispatch model, Staff did not include Noxon #1 project in PF-7 (which represented  
12 various unrelated projects). Instead, Staff has included both projects in PF-8. Staff also  
13 adjusted Noxon #3 for the fact that it will be used and useful for only nine months of the  
14 rate year. Therefore, the invested cost was weighted so that recovery will be equal to  
15 nine months consistent and matched to the benefits measured in the pro forma power cost  
16 adjustment.

17

18 **Q. What is the impact of Staff's pro forma adjustment for the Noxon upgrade**  
19 **projects?**

20 A. Staff's proposed adjustment increases net rate base by \$13,999,000 and increases  
21 operating expenses by \$156,000, or reduces net operating income after taxes by  
22 \$101,000. Including return on investment and increased expenses, the net effect of this  
23 adjustment increases revenue requirement by \$2,117,000, a increase of revenue

1 requirement of \$1,114,000 from the Company proposed \$1,003,000 due to the addition of  
2 Noxon #1.

3  
4 **G. Asset Management — PF-9 (Electric) PF-6 (Gas)**

5  
6 **Q. Please discuss the Company’s adjustment for Asset Management.**

7 A. Avista’s Asset Management program manages key assets of its transmission and  
8 distribution system. The Asset Management program uses a comprehensive “Asset  
9 Management Model” to evaluate assets and for the development of an asset management  
10 plan.<sup>19</sup> Using projections of a future costs, the Company’s PF-9 (electric) increases  
11 Washington’s electric operations test year expenses by \$2.9 million decreasing net  
12 operating income by \$1.9 million. Whereas, PF-6 (gas) increases Washington’s gas  
13 operations test year expenses by \$88,000, decreasing net operating income by \$57,000.

14  
15 **Q. Does the Company’s adjustment conform to the definition of a pro forma  
16 adjustment as set out in WAC 480-09-330(2)(b)(ii)?**

17 A. No. The adjustment does not represent an adjustment for known and measurable changes  
18 in the test year operations for either its electric or gas operations. Nor does the  
19 adjustment attempt to quantify the myriad of benefits that Mr. Scott Kinney describes in  
20 his testimony. For example, Mr. Kinney states that the Asset Management program

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<sup>19</sup> Testimony of Scott J. Kinney, Exhibit No. \_\_\_\_ (SJK-1T), page 19, lines 10-19.

1 “maximize[s] system reliability and value for our customers.”<sup>20</sup> Yet there are no  
2 offsetting amounts for increased revenue or clear decreases in test year costs.

3  
4 **Q. To your knowledge, are there adjustments embedded within the larger overall**  
5 **adjustment that meets the definition of a pro forma adjustment which would**  
6 **acceptable for rate making purposes?**

7 A. To my knowledge there are none. After review of the Company’s work papers and  
8 examination of the Company responses to data requests from both Staff and Public  
9 Counsel addressing these adjustments, it is Staff’s opinion that, there are not any  
10 proposed changes in expenses embedded in the Company’s Asset Management  
11 adjustment that met the definition of a pro forma adjustment at the time of filing. From a  
12 regulatory audit standpoint, the Company failed in its burden to clearly demonstrate that  
13 any individual adjustment item was known and measurable, with all offsetting factors  
14 identified.

15  
16 **Q. Does Staff accept the Company’s adjustments PF-9 (Electric) PF-6 (Gas)?**

17 A. No. Both proposed adjustments fail as an acceptable pro forma adjustment because they  
18 are not based on known and measurable situation, event, or cause but are, in the most part  
19 estimates and/or management’s judgment of future expenses at the time the case was  
20 filed. Review of the proposed adjustments shows that the proposed increase in test year

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<sup>20</sup> Testimony of Scott J. Kinney, Exhibit No. \_\_\_\_ (SJK-1T), page 19, lines 12-13

1 expenses are a compilation of eleven expense accounts with estimates of amounts based  
2 2010 expected expenses. PF-6 (Electric) and PF-4 (Gas) should be rejected.

3  
4 **H. Information Services — PF-10 (Electric) PF-8 (Gas)**

5  
6 **Q. Please discuss the Company’s adjustment for Information Services.**

7 A. The Company’s pro forma adjustment for information services related costs increases  
8 Washington electric operations expenses \$1.8 million and Washington gas operations  
9 expenses by \$450,000. The adjustment uses planned 2010 costs above the test year  
10 costs.<sup>21</sup>

11  
12 **Q. Are “Planned” costs a basis for supporting the “known and measurable”**  
13 **requirement in a pro forma adjustment?**

14 A. No. “Planned costs” as used by Mr. Don Kopczynski in his testimony are simply  
15 budgeted costs and not known and measurable, contrary to his testimony.<sup>22</sup> The  
16 Company’s pro forma adjustment for information services related cost increases include  
17 incremental costs reflected in 16 different categories, all classified under “Information  
18 Services.” The Company’s work paper (PF8<sub>3</sub>) details the proposed increase in costs with  
19 a general description of the reason. For example, the increase in Wireless Wide-Area-  
20 Network costs of \$174,000 is labeled as “[additional] communications costs for  
21 additional mobile computer devices.” As to the support for this portion of the Company’s

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<sup>21</sup> Testimony of Don F. Kopczynski, Exhibit No. \_\_\_\_ (DFK-1T), page 7, lines 22-26.

1 pro forma adjustment, the Company's work papers stop there. The Company employs a  
2 similar approach with the remaining 15 categories of costs. Effectively, the Company is  
3 attempting to shift to Staff the responsibility to build detailed support for the proposed  
4 Company adjustments, through audits or data requests.

5  
6 **Q. Does the Company's adjustment conform to the definition of a pro forma  
7 adjustment as set out in WAC 480-09-330(2)(b)(ii)?**

8 A. No. The adjustment does not represent an adjustment for known and measurable changes  
9 to the test year for either its electric or gas operations. Nor does the adjustment attempt  
10 to quantify any offsetting benefits of the pro formed costs. Testimony supporting the  
11 proposed adjustment was limited to one question and answer in Mr. Kopczynski's  
12 testimony and one short response each in the electric and gas portions of Ms. Andrews'  
13 testimony.

14  
15 **Q. Does Staff accept the Company's adjustments PF-10 (Electric) PF-8 (Gas)?**

16 A. No. Both proposed adjustments fail as an acceptable pro forma adjustment because they  
17 are not based on a known and measurable situation, event, or cause, with all offsetting  
18 factors identified, but are merely estimates of future expenses at the time the case was  
19 filed. PF-10 (Electric) and PF-8 (Gas) should be rejected.

20

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

1 **I. Pension Assets and Employee Benefits — PF-17 (Electric) PF-9 (Gas)**

2

3 **Q. Please summarize Avista’s proposal for cash contributions to its pension plan.**

4 A. As described by Avista Witness Mark Thies in his testimony, Avista proposes to establish  
5 a regulatory asset for the “carrying costs” of the Company’s actual cash contribution to  
6 its pension fund based on the difference between the pension cost embedded in rates and  
7 the cash pension payment.<sup>23</sup>

8

9 **Q. When does the Company propose to start the accrual of the carrying cost and at  
10 what rate?**

11 A. Avista proposes to begin the accrual of the carrying cost retroactively as of February 1,  
12 2009. The accrual would earn a return at the Company’s allowed rate of return of 8.43%,  
13 the overall return on investment set in its last general rate case.

14

15 **Q. Why does the Company make this request?**

16 A. Mr. Thies testifies that the negative performance of the financial markets over the past  
17 year has increased the pension expense and substantially increased the Company’s  
18 required contributions to the pension fund.

19 One major reason for the requirement to increase pension contributions is the  
20 Pension Protection Act passed by Congress in 2006, which requires corporate pension

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<sup>23</sup> Testimony of Mark Thies, Exhibit No. \_\_\_ (MTT-1T), page 37, lines 6-13.

1 funding of at least 94% of the pension obligation in 2009.<sup>24</sup>

2  
3 **Q. Does Staff dispute the Company's claim of the need to increase its pension fund**  
4 **contributions?**

5 A. No.

6  
7 **Q. Has the Company's pension fund cash contribution varied from year to year?**

8 A. Yes. As depicted by Mr. Thies, the pension cash contributions ranged from zero to \$3.3  
9 million between 1992 and 2001. After the market declines of the early 2000s, the  
10 contributions have increased to between \$12 million and last year's funding of \$28  
11 million.<sup>25</sup>

12  
13 **Q. Does the pension fund earn a return on its assets?**

14 A. Yes. The return on the assets of the pension fund is an integral component of the  
15 Company's ability to meet its pension obligations of the future.

16  
17 **Q. Does this return vary over time?**

18 A. Yes. The return on the pension asset has shown returns as high as plus 24% to its low of  
19 minus 25% in 2008.<sup>26</sup>

20  
21 **Q. Have Avista's pension returns shown further declines in 2009?**

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<sup>24</sup> Internal Revenue Code §430(c)(5)(B).

<sup>25</sup> Exhibit No. \_\_\_\_ (MTT-1T), Illustration No. 7 at 36.

1 A. No. The most recent report shows Avista's pension fund earned a return of plus 6.2  
2 percent for the first half of 2009.<sup>27</sup>

3

4 **Q. Does Staff question the prudence of Avista's management of its pension fund?**

5 A. No.

6

7 **Q. Does Staff accept Avista's proposal to accrue a carrying charge on the difference**  
8 **between its pension expense and the cash contribution to the pension fund?**

9 A. No.

10

11 **Q. Please explain the reasons for Staff's opposition to allowing a carrying charge on the**  
12 **difference between its pension expense and the cash contribution.**

13 A. The primary reason is the mere fact that the pension fund earns its own return. Staff  
14 views Avista's proposal as giving the opportunity for Avista to earn two returns on one  
15 investment. The Company earns one return through the fund itself, and under the  
16 Company's proposal, it earns a second return via the carrying charge which gives the  
17 Company interest income. This is not a reasonable approach.

18 Second, Staff points out the wide latitude a corporation has in deciding its annual  
19 contribution to its pension fund. For instance, Avista's minimum required contribution in  
20 2008 was zero, and its maximum contribution was \$225,493,150.<sup>28</sup> This degree of  
21 discretion, together with the requested regulatory treatment that would allow for a double

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<sup>26</sup> Response to Staff Data Request 33.

<sup>27</sup> Response to Public Counsel Data Request 467.

1 return on the Company's investment, creates incentives for excess contributions above  
2 what would normally be contributed.

3  
4 **Q. Does Staff accept the Company's proposed increase to pension expense embedded in  
5 the line item Employee Benefits, adjustment PF17 for electric and PF-9 for gas?**

6 A. No. Based on newer and updated actuarial information, it appears that pension expense is  
7 greater than the original levels shown in the Company's exhibits.

8  
9 **Q. What is Staff's proposal for pension expense in this case?**

10 A. Staff's review of the revised 2009 pension expense that was provided by the Company,  
11 shows an increase of \$1.8 million.<sup>29</sup> After allocation, the Washington portion of the  
12 revised pension expense results in an increase in revenue requirement of \$552,000 for  
13 electricity and an increase of \$145,000 for natural gas over the amount requested by the  
14 Company in its filed case.

## 15 VIII. CONCLUSION

16  
17 **Q. Please summarize Staff's revenue requirement analysis for Avista's electric  
18 operations.**

19 A. Staff's revenue requirement analysis shows that Avista's electric operations, on a pro  
20 forma basis, are earning 6.88 percent return on its invested rate base. Staff's  
21 recommended authorized return on investment is 8.13 percent. As a result, Staff's

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<sup>28</sup> Response to Staff Data Request 28, attachment A.

<sup>29</sup> Response to Public Counsel Data Request 432.

1 analysis supports an additional electric revenue requirement of \$20,109,000, an overall  
2 increase in test year revenues of 5.15 percent.

3

4 **Q. Please summarize Staff's revenue requirement analysis for Avista's natural gas**  
5 **operations.**

6 A. Staff's revenue requirement analysis shows that Avista's natural gas operations, on a pro  
7 forma basis, are earning 8.03 percent return on its invested rate base. Staff's  
8 recommended authorized return on investment is 8.13 percent. Staff's analysis supports  
9 an additional gas revenue requirement of \$280,000, an overall increase in test year  
10 revenues of 0.13 percent.

11

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

13 A. Yes.