

Exhibit _____ (MRL-1T)
Docket No. UE-010395
Witness: Merton R. Lott

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Avista Corporation's) DOCKET NO. UE-010395
Petition for Recovery of Expenditures)
Related to Electric Deferral Mechanism)
_____)

TESTIMONY OF
MERTON R. LOTT

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

RE: AVISTA PETITION FOR 37% EMERGENCY SURCHARGE

August 24, 2001

1 Q. PLEASE STATE YOUR NAME AND ADDRESS.

2 A. My name is Merton R. Lott. My business address is 1300 S. Evergreen Park Drive S.W.,
3 P.O. Box 47250, Olympia, WA 98504-7250.

4

5 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

6 A. I am employed by the Washington Utilities and Transportation Commission as the
7 Energy Coordinator.

8

9 Q. HOW LONG HAVE YOU BEEN EMPLOYED BY THE COMMISSION?

10 A. Over 27 years.

11

12 Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND AND
13 EXPERIENCE AT THE COMMISSION.

14 A. I received a Bachelor of Arts Degree in Business Administration, with a major in
15 accounting, from Seattle University in June 1973. I am a certified public accountant in
16 the state of Washington and have taken numerous courses in accounting, management,
17 and regulation theory and practice in order to maintain the continuing CPA education
18 requirements of the state of Washington: I have been employed by the Commission since
19 May 1974. Further, I have represented this Commission on the NARUC Staff
20 Subcommittee on Accounts since approximately 1991.

21 Prior to July 1990, I was employed by the Utilities and Accounting Division of
22 the Commission in an auditing and then supervisory capacity. During this period, I
23 performed various phases of accounting and financial analysis of both utility and

1 transportation companies. I worked on the investigation of Washington Natural Gas
2 Company (WNG) in Cause No. U-80-27. I was lead auditor in the filings of Pacific
3 Power and Light (PacifiCorp), Cause Nos. U-82-12/35 and U-86-02; The Washington
4 Water Power Company(WWP), Cause Nos. U-83-26, U-85-36, U-87-1570 and Docket
5 No. UE-900093; and Puget Sound Power & Light (Puget), Cause No. U-83-54 and
6 Docket No. U-89-2688. Further, I was in charge of Staff's analysis of attrition in Cause
7 Nos. U-83-26, U-83-54 and U-86-02. I audited Spokane Suburban and Clarkston
8 General Water companies in Cause Nos. U-84-45 and U-84-46. I participated as lead
9 auditor in the determination of proper rates and principles negotiation with United
10 Telephone. I was also the lead auditor in the analysis of General Telephone (GTE) that
11 led to its filing in Cause No. U-85-33. I was the lead analyst in Continental Telephone's
12 (Contel) filing in Cause No. U-87-640-T. Further, I participated in and/or testified in
13 various limited issue filings in gas, electric and telephone proceedings, including several
14 ECAC proceedings, the reopened Cause No. U-81-41, PacifiCorp's merger proceeding in
15 Cause No. U-87-1338-AT, and WWP's PCA proposal in Docket No. U-88-2363-P. I
16 participated as either lead analyst or as a supervisor in 22 of Puget's ECAC proceedings
17 starting with the third trimester. During this period, I testified in several of the dockets
18 listed above.

19 In July 1990, I transferred to the Regulatory Affairs Section as the Commission's
20 accounting advisor. In this capacity, I advised the Commissioners and Administrative
21 Law Judges on most of the formal dockets before the Commission, including major rate
22 cases of WNG, Puget, Waste Management, and U S West; cost of service and rate design
23 cases of WWP, Puget, WNG and U S West; merger dockets of WWP, U S West, GTE

1 and Contel; purchased gas adjustment and deferral proceedings; all of Puget's PRAM
2 proceedings; and various rule makings and notices of inquiries.

3 In June 1996, I transferred to the Regulatory Services Division as the Gas
4 Industry Coordinator, where I coordinated and supervised the Division's Gas Section.
5 Under my supervision, Staff processed several tariff filings and rulemakings, including
6 the 1997 and 2000 general rate filings of WWP (gas) and Northwest Natural Gas. I also
7 participated in several electric dockets including PacifiCorp's general rate case in Docket
8 No. UE-991832, and on occasion, acted as the accounting advisor to the Commission in a
9 number of telephone proceedings.

10 In January 2001, the gas and electric sections were reunited and I was given the
11 title of Energy Coordinator.

12
13 Q. DO YOU SPONSOR ANY EXHIBITS IN SUPPORT OF YOUR TESTIMONY?

14 A. Yes, I sponsor Exhibits _____ (MRL-2) through Exhibit _____ (MRL-5).

15
16 Q. WOULD YOU PLEASE EXPLAIN YOUR ASSIGNMENT IN THIS DOCKET?

17 A. I describe what a regulatory asset is, and the requirements for creating a regulatory asset.
18 I apply those requirements to the power cost deferrals first established in July 2000 for
19 Avista.

20
21 Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

22 A. I conclude that the Commission did not create a regulatory asset, under the Uniform
23 system of accounts prescribed by this Commission, in either of its orders in Docket No.

1 UE-000972, issued August 9, 2000, and January 24, 2001. Further, I conclude that the
2 deferrals approved by the Commission should not be treated as regulatory assets on the
3 company's financial statements under Generally Accepted Accounting Principles.
4

5 Q. WHAT IS A REGULATORY ASSET?

6 A. Regulatory assets are defined by both the Financial Accounting Standards Board in
7 Statement of Financial Accounting Standards No. 71, ("FAS 71"), and the "Uniform
8 System of Accounts" applicable to class A and B electric utilities published by the
9 Federal Energy Regulatory Commission (FERC system of accounts). The FERC system
10 of accounts has been adopted by this Commission for electric and gas utilities such as
11 Avista. See WAC 480-100-203. The FERC system of accounts states in definition 30:
12 "Regulatory Assets and Liabilities are assets and liabilities that result from rate actions of
13 regulatory agencies. Regulatory assets and liabilities arise from specific revenues,
14 expenses, gains, or losses that would have been included in net income determination in
15 one period under the general requirements of the Uniform System of Accounts but for it
16 being probable:

- 17 A. that such items will be included in different period(s) for purposes of developing
18 the rates the utility is authorized to charge for its utility services; or
19 B. in the case of regulatory liabilities, that refunds to customers, not provided for in
20 other accounts, will be required."

21 FAS 71 establishes the general standards of accounting for the effects of regulation.

22 Paragraph 9 of FAS 71 states:

1 “Rate actions of a regulator can provide reasonable assurance of the existence of an
2 asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise
3 be charged to expense if both of the following criteria are met:

- 4 a. It is probable that future revenue in an amount at least equal to the capitalized cost
5 will result from inclusion of that cost in allowable costs for rate making purposes.
6 b. Based on available evidence, the future revenue will be provided to permit
7 recovery of the previously incurred cost rather than to provide for expected levels
8 of similar future costs. If the revenue will be provided through an automatic rate-
9 adjustment clause, this criterion requires that the regulator’s intent clearly be to
10 permit recovery of the previously incurred cost.”

11
12 Q. DID AVISTA’S JUNE 23, 2000, PETITION IN DOCKET NO. UE-000972 REQUEST
13 THE ESTABLISHMENT OF A REGULATORY ASSET CONSISTENT WITH THE
14 FERC SYSTEM OF ACCOUNTS?

15 A. Yes. On page two of the petition Avista stated: “The Company requests an accounting
16 order authorizing it to defer the increased expenses as a regulatory asset to consider for
17 recovery later.” The petition requested permission to defer costs that otherwise would
18 have been expensed in the current period. Further, the company proposed how these
19 costs would be treated for future rates. Avista proposed two scenarios for ultimate rate
20 recovery. First, if the Company’s proposed Power Cost Adjustment (PCA) proposal in
21 the then pending general rate case were adopted, Avista proposed that the deferral would
22 terminate and the balance could be passed through over a two-year period. Second, if the
23 PCA was not adopted, then at the end of the one-year deferral period (June 30, 2001), the

1 deferral balance would be amortized over a ten-year period. While no specific rate
2 analysis is included in the second proposal, future rate filings would determine total
3 revenue requirements based on costs that would include the deferral and its amortization.
4 The Company did propose conditioning the recovery of these costs to a prudence review,
5 but this condition is not different from the inclusion of any cost in a rate determination
6 when test year operating expenses or capital investments are included in the revenue
7 requirement.

8
9 Q. DID AVISTA'S JUNE 23, 2000, PETITION IN DOCKET NO. UE-000972 ALSO
10 REQUEST THAT THE COMMISSION PERMIT THE COMPANY TO CREATE THE
11 POWER COST DEFERRALS AS REGULATORY ASSETS UNDER FAS 71?

12 A. No. Such a request would not have been meaningful. This Commission has no authority
13 or power to unilaterally establish regulatory assets under Generally Accepted Accounting
14 Principles (GAAP). Whether a regulatory asset is created depends on whether FAS 71
15 applies, considering the Commission actions and all other relevant factors.

16
17 Q. DID THE COMMISSION'S AUGUST 9, 2000 ORDER AUTHORIZING DEFERRAL
18 ACCOUNTING AUTHORIZE AVISTA TO CREATE A REGULATORY ASSET WITH
19 RESPECT TO THE POWER COSTS DEFERRED?

20 A. No. While the Commission authorized Avista to defer certain costs for future
21 consideration, no level of alternative rate recovery was established, nor was prudence of
22 the costs the sole determinative factor in allowing rate recovery. Ex_____(MRL-3) is a
23 copy of Staff's memorandum to the Commission describing the accounting treatment and

1 the treatment of amounts in Account 186. That memo clearly states this account was
2 being used because recovery of these deferred costs was uncertain.

3
4 Q. WAS THE UNCERTAINTY OF RECOVERY REFLECTED IN THE CONDITIONS
5 REQUIRED BY THE COMMISSION IN THE AUGUST 9, 2000, ORDER
6 APPROVING AVISTA'S JUNE 23, 2000, PETITION?

7 A. Yes. The Commission stated that its order "shall in no way affect the authority of the
8 Commission over rates, services, accounts evaluations, estimates, or determination of
9 cost or any matter whatsoever that may come before it, nor shall anything herein be
10 construed as an acquiescence in any estimate or determination of cost claimed or
11 asserted." (Ordering paragraph 4).

12 The Commission conditioned its approval of Avista's petition in other important
13 respects. The Commission stated that under its general ratemaking authority, it "has the
14 ability in subsequent Avista rate proceedings to evaluate the reasonableness of the
15 Company's expenditure." The Commission also stated, "The Company bears the burden
16 of proof in any such proceeding regarding these matters to show that such costs were
17 prudently incurred, that Company-owned resources have been optimized for the benefit
18 of retail customers, and that recovery of these costs through a deferral mechanism is
19 appropriate." (Ordering paragraph 3).

20
21 Q. DO THESE CONDITIONS MEAN THAT RECOVERY OF THESE DEFERRED
22 COSTS WAS UNCERTAIN?

1 A. Yes. The Commission did not provide reasonable assurance of recovery. This is
2 particularly true of the requirement that Avista prove that “recovery of these costs
3 through a deferral mechanism was appropriate.” There was discussion about this issue
4 during the Commission’s August 9th open public meeting when Avista’s first petition was
5 addressed. A transcript of that meeting reflects that some parties opposed Avista’s
6 petition on several bases, including the basis that Avista would defer power costs was not
7 appropriate, and that the proper base from which deferral is appropriate was an
8 unresolved issue. The Commissioners gave assurances that in approving deferral
9 accounting, it was deciding none of these issues. The transcript of the August 9th open
10 public meeting is my Exhibit ____ (MRL-4).

11

12 Q. DID AVISTA SEEK TO MODIFY THE AUGUST 9, 2000, ORDER?

13 A. Yes. On December 21, 2000, Avista filed a petition to modify the August 9, 2000 Order.

14

15 Q. DID THE COMMISSION’S JANUARY 24, 2001, ORDER ELIMINATE ANY OF THE
16 CONDITIONS INCLUDED IN THE AUGUST 9, 2000, ORDER?

17 A. No. In fact, the January 24th order further clarified and expanded the requirements on the
18 Company. The Commission accepted the Company’s proposed modification only if the
19 Company filed testimony and exhibits by mid-March 2001 to demonstrate: “a) the
20 prudence of the incurred power costs; b) the optimization of Company-owned resources
21 to the benefit of retail customers; c) the appropriateness of recovery of power costs
22 through a deferral mechanism; d) a proposal for cost of capital offsets to recognize the
23 shift in risk from shareholders to ratepayers, and e) Company’s plan to mitigate the

1 deferred power costs.” (Ordering paragraph 2). The Commission also reiterated its
2 earlier condition that approval “shall in no way affect the authority of the Commission
3 over rates, services, accounts, evaluations, estimates, or determination of cost or any
4 matter whatsoever that may come before it, nor shall anything herein be construed as an
5 acquiescence in any estimate or determination of costs claimed or asserted.” (Ordering
6 paragraph 4).

7
8 Q. DID THIS JANUARY 24TH ORDER PROVIDE FOR THE CREATION OF A
9 REGULATORY ASSET WITH RESPECT TO THE POWER COSTS DEFERRED?

10 A. No. The Company was to continue to record the deferred power costs as previously
11 authorized by the Commission’s initial order in that docket.

12
13 Q. HAS AVISTA TREATED THE DEFERRALS AS REGULATORY ASSETS?

14 A. Yes. Avista included these power cost deferrals in its financial statements to the public,
15 including its annual report and SEC Form 10-K. Such reporting can only mean that
16 Avista considers the deferrals to meet the requirements of FAS 71 as a regulatory asset.
17 Further, on page 52 of Avista’s SEC Form 10-K, and on page 30 of Avista’s “2000
18 Financial Report,” Appendix A, Avista identified deferred power costs as one of its
19 “primary regulatory assets.”

20
21 Q. HAVE YOU EXAMINED HOW AVISTA CHARACTERIZED ITS POWER COST
22 DEFERRALS IN ITS ANNUAL REPORTS TO STOCKHOLDERS AND ITS

1 REPORTS TO THE SECURITIES AND EXCHANGE COMMISSION, FORMS 10-K
2 AND 10-Q?

3 A. Yes. My Exhibit ____ (MRL-2) contains relevant excerpts from Avista's SEC Form 10-
4 Q and 10-K. My Exhibit ____ (MRL-5) contains the actual Forms 10-Q and 10-K Avista
5 filed with the SEC.

6
7 Q. IN YOUR OPINION, IS IT APPROPRIATE FOR AVISTA TO TREAT DEFERRED
8 POWER COSTS AS A REGULARY ASSET?

9 A. No. The key requirement in FAS 71 is that probable future revenue in an amount at least
10 equal to the capitalized cost will result from inclusion of that cost in allowable costs for
11 rate making purposes. (FAS 71, paragraph 9 a.) "Probable," as that term is used in FAS
12 71, is defined according to its usual meaning, rather than in a specific technical sense.
13 (FAS 71, footnote 6). Webster's New World Dictionary defines "probable" as: "likely
14 to occur or be; that can be reasonably but not certainly expected." Therefore, in order
15 for Avista to book these deferrals in its published financial statements, it would have to
16 conclude that 100% of the deferred amounts would probably be recovered by inclusion of
17 the costs in a ratemaking procedure.

18 In my opinion, the deferral accounting established in Docket No. UE-000972 did
19 not meet the requirements of recovery through acceptance as allowable costs in a rate
20 proceeding. Positions of the parties and comments by the Commission at its August 9,
21 2000 open meeting indicate that permission to recover 100% of these deferred costs was
22 not probable. Further, the order issued on August 9, 2000 identified issues which, when
23 analyzed, would make it unlikely that 100% of the deferrals would be recovered in rates,

1 assuming recovery was found appropriate at all. The Commission required, in addition to
2 the normal requirement in a deferral mechanism to demonstrate prudence of the costs in
3 question, that Avista also demonstrate that it had optimized its resources to the benefit of
4 the retail customers. Most importantly, the Company was required to bear the burden of
5 proof to demonstrate that it was appropriate to recover these costs through a deferral
6 mechanism.

7 At the August 9, 2000, open meeting, various parties made comments that would
8 cast doubt on a full level of recovery. Staff raised the questions of: What was
9 extraordinary, and how do you measure it? Would emergency rate relief standards be
10 applied? And should wholesale customers be partially held responsible? Public Counsel,
11 who was opposed to the accounting order, raised the issue of the accounting order putting
12 unreasonable pressure on the Commission to later presume that the deferrals were
13 recoverable. Chairwoman Showalter, responding to Public Counsel's concern, stated her
14 understanding of the action being taken by stating "...I don't think this creates a
15 presumption one way or the other." Industrial Customers of Northwest Utilities (ICNU)
16 also opposed the deferrals. Among the issues ICNU identified were issues concerning
17 the appropriateness of a PCA for costs not related to weather, and the absence of a cost of
18 capital adjustment. Confronted with these numerous issues, none of the Commissioners
19 gave any commitment on the issue of recovery of power costs deferred.

20
21 Q. DOES THAT COMPLETE YOUR DIRECT TESTIMONY?

22 A. Yes.