Exhibit No. ___(EMA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12______________

DOCKET NO. UG-12______________

DIRECT TESTIMONY OF

ELIZABETH M. ANDREWS

REPRESENTING AVISTA CORPORATION

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I. INTRODUCTION

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

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

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

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

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

A. As Manager of Revenue Requirements, aside from special projects, I am responsible for the preparation of normalized revenue requirement and pro forma studies for the various jurisdictions in which the Company provides utility services. Since 2000, I have

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

assisted or led the Company's electric and/or natural gas general rate filings in Washington, Idaho and Oregon.

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

A. My testimony and exhibits in this proceeding will generally cover accounting and financial data in support of the Company's need for the proposed increase in rates. I will explain pro formed operating results, including expense and rate base adjustments made to actual operating results and rate base. I incorporate the Washington share of the proposed adjustments of other witnesses in this case. In addition, I have incorporated the impact of "attrition" in the overall revenue requirements. Lastly, I will explain the Company's compliance with the UTC Commission Order No. 6 in Docket Nos. UE-110876 and UG-110877, regarding 1) the Company's deferred accounting treatment for the variability in thermal generating plant maintenance costs, 2) the tracking of Washington general rate case expenses and 3) the internal audit of accounting practices.[2]

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

A. Yes. I am sponsoring Exhibit Nos.____(EMA-2) (Electric), and ___(EMA-3) (Natural Gas), which were prepared under my direction. These exhibits consist of worksheets, which show actual 2011 operating results (twelve-month period ending December 31, 2011), pro forma, and proposed electric and natural gas operating results and rate base for the State of Washington. The exhibits also show the calculation of the general revenue requirement, the derivation of the Company's overall proposed rate of return, the

[2] Order No. 6, Docket Nos. UE-110876 & UG-110877, Appendix A - Settlement Stipulation, page 12, paragraph 15.

derivation of the net-operating-income-to-gross-revenue-conversion factor, and the specific pro forma adjustments proposed in this filing. They also reflect the attrition adjustments in this case.

I am also sponsoring Exhibit No. ___(EMA-4), which includes the "Accounting Practices Audit" & the "Low-Income Rate Assistance Program (LIRAP) – Accounting Practices Audit" reports.

II. COMBINED REVENUE REQUIREMENT SUMMARY

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

A. Yes. After taking into account all standard Commission Basis adjustments, as well as additional pro forma and normalizing adjustments, the pro forma electric and natural gas rates of return ("ROR") for the Company's Washington jurisdictional operations are 6.17% and 5.27%, respectively. Both return levels are below the Company's requested rate of return of 8.25%. The incremental revenue requirement necessary to give the Company an opportunity to earn its requested ROR is $40,983,000 for the electric operations and $10,088,000 for the natural gas operations. The overall base electric increase associated with this request is 9.01%. The base natural gas increase is 7.00%.

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

A. The last authorized rate of return by this Commission for both the Company's electric and natural gas operations in its Washington jurisdiction was 7.91%, approved in Docket Nos. UE-100467 and UG-100468, effective December 1, 2010. Order No. 06 in Docket Nos. UE-110876 and UG-110877, effective January 1, 2012, approved the Settlement agreed to by the parties and incorporated a 7.62% ROR for the limited purpose of recording AFUDC expenses and other compliance filings only. The parties did not otherwise reach agreement on a specific capital structure or assign values to the various cost of capital components.

III. ELECTRIC SECTION

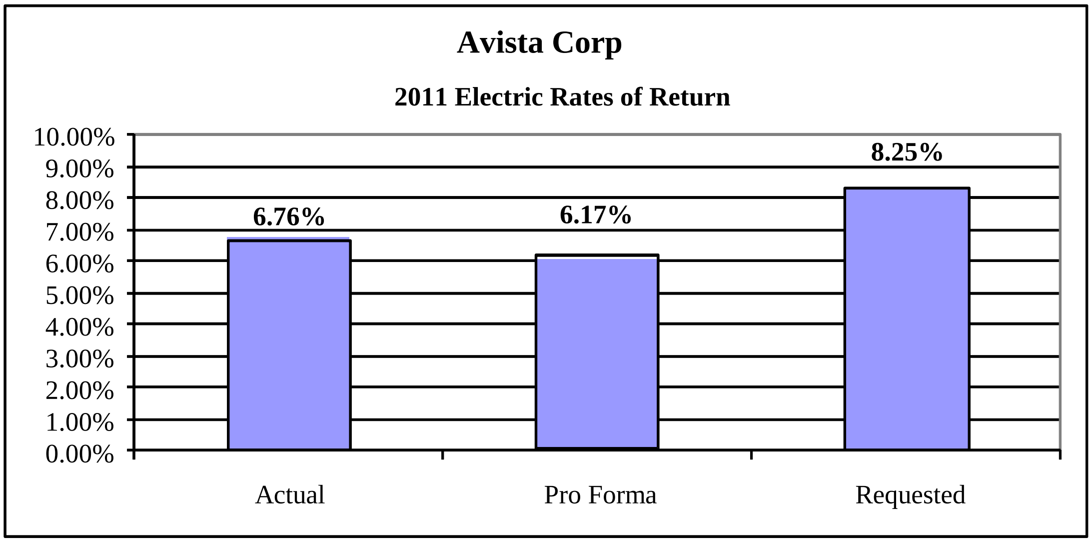
Q. On what test period is the Company basing its need for additional electric revenue?

A. The test period being used by the Company is the twelve-month period ending December 31, 2011, presented on a pro forma basis. Currently authorized rates were based upon the twelve-months ending December 31, 2010 test year utilized in UE-110876, adjusted on a pro forma basis.

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

A. Yes. Basically, there are three different rates of return that will be discussed. The actual ROR earned by the Company during the test period, the pro forma ROR determined in my Exhibit No.___(EMA-2), and the requested ROR. For comparison, please refer to Illustration No. 1 below:

Illustration No. 1

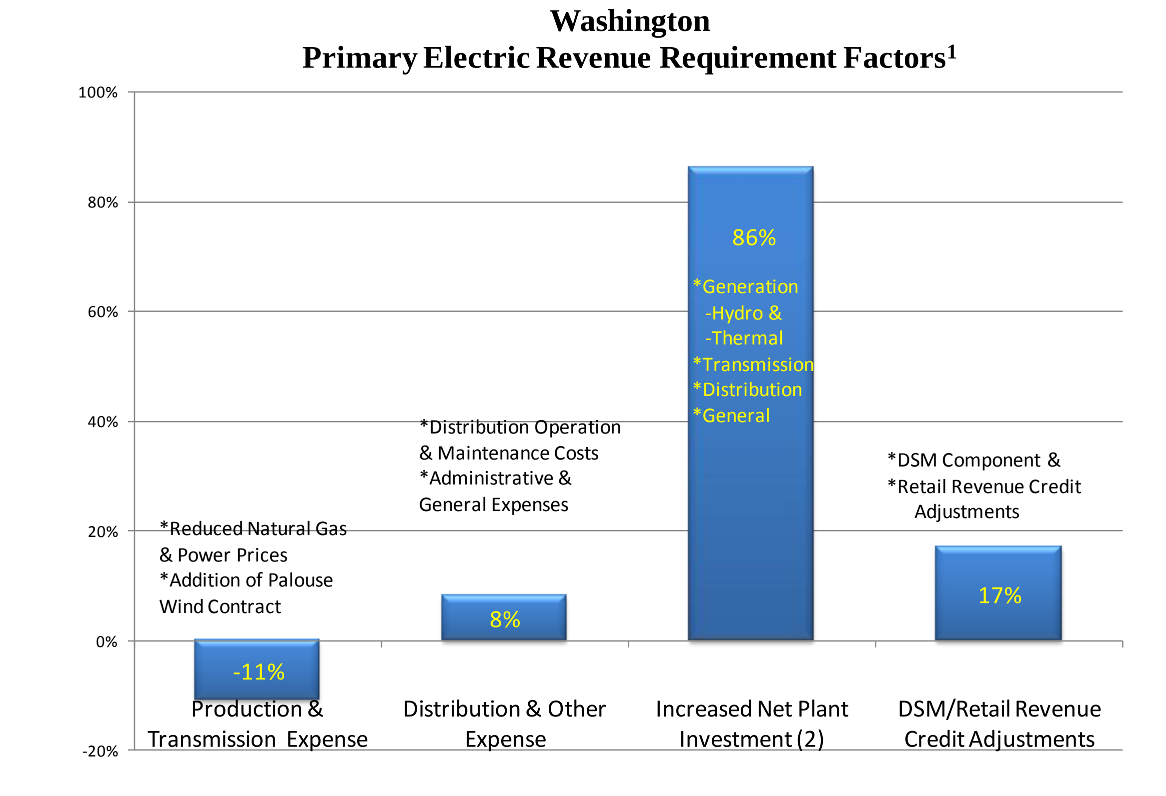


Q. What are the primary factors driving the Company's need for an electric increase?

A. Illustration No. 2 below shows the primary factors driving the electric revenue requirement in this case. Additional details regarding these items are provided later in my testimony.[3]

[3] The items discussed below related to Illustration No. 2 represent an approximate breakdown of amounts between the Company's request in this case compared to that approved in the Company's prior general rate case proceeding (Docket Nos. UE-100467 and UG-100468). Due to the black-box nature of the Company's prior settlement approved by the WUTC in Docket No. UE-110876, the Company made certain assumptions as to the amounts approved for various rate base and expense items in order to create the comparison used in Illustration No.2, and the discussion that follows.

Illustration No. 2



[1]This chart represents the approximate breakdown of revenue requirement for the major cost categories.
[2]Includes return on investment, depreciation and taxes, offset by the tax benefit of interest.

Q. Please briefly explain each of the four columns shown in Illustration No. 2 above.

A. The largest column, representing increases in Net Plant Investment, comprises approximately 86% of the overall request, and is due to an increase of approximately $82.7 million in net rate base for the Washington jurisdiction, reflected in the pro forma and attrition adjustments in this case.

The next three columns represent the following: 1) the Production and Transmission Expense column shows a net reduction of 11%, related to decreases in net power supply and transmission expenditures; 2) the Distribution and Other Expense column shows a net increase of 8%, related to increases in net operation and maintenance (O&M) and administrative and general (A&G) expenses; and lastly 3) the Demand Side Management (DSM)/Retail Revenue Credit Adjustments column shows a net increase of 17%, representing the cost related to a shortfall in current and future revenues experienced by the Company for its DSM energy efficiency programs and the impact of necessary corrections to the retail revenue credit rate.

Each of these components are summarized in my more detail in my testimony below.

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

A. Looking at the changes to "gross" plant in service, Washington "gross" plant increased by approximately $243.8 million, as compared to what is currently included in rates. In order to meet the energy and reliability needs of our customers, $66.4 million of this increase is due to the Company's investment in thermal and hydro-generating facilities, as well as additional transmission investment. Distribution "gross" plant increased $115.8 million above the current level included in rates, while general and intangible "gross" plant increased $61.6 million. After adjusting for accumulated depreciation and amortization, and accumulated deferred income taxes, the net increase to rate base from these items is $90.6 million. The Company also included a working capital adjustment in this case of $31.9 million. Lastly, the Company included a reduction related to miscellaneous regulatory items of $3.6 million.

The specific 2012 and 2013 planned capital expenditures undertaken by the Company to expand and replace its generation, transmission and distribution facilities are discussed further by Company witness Mr. Lafferty regarding production assets, and Company witness Mr. Kinney regarding transmission and electric distribution assets. In addition to discussing the actual restating and pro forma adjustments made regarding net plant investment, Company witness Mr. DeFelice also describes the planned 2012 and 2013 general plant and gas distribution plant investments, as well as the 2011 plant additions (generation, transmission, distribution, and general plant) annualized for purposes of the Company's case.

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

A. Yes. As discussed in Company witness Mr. Johnson's testimony, the level of Washington's share of power supply expense has decreased by approximately $11.1 million ($17.1 million on a system basis) from the level currently in base rates, and this is after taking into account the effect of the new power purchase agreement with Palouse Wind, LLC (discussed by Mr. Lafferty).

This decrease in pro forma power supply expense from the expense currently in base rates is primarily a result of lower natural gas and power prices.

Q. Could you please identify the main components of the Distribution, O&M and A&G Expense shown in Illustration No. 2 above?

A. Yes. A number of expense items have increased since the 2010 test year pro forma used in the last rate case. For example, employee benefits such as wages, pension and medical insurance expenses have increased.

We are utilizing a 2011 test year; however, new general electric rates resulting from this filing are not expected to go into effect until the first half of 2013. Accordingly, the Company has included a number of pro forma adjustments to capture some of the cost changes that the Company will experience from the test year. In particular, the Company has pro formed in the increased costs associated with employee salaries, pension and medical expenses of approximately $3.7 million (distribution and A&G portions). Company witness Ms. Feltes discusses the cause of the increased pension and medical expenses in her testimony, along with the overall compensation levels of all Company employees.

These increases are partially offset by the decreases in distribution O&M included in the Company's filing related to new plant investment, providing expected savings in the 2013 rate year of approximately $910,000. Mr. Lafferty, Mr. Kinney and Mr. DeFelice discuss these O&M offsets in further detail in their testimonies. The net of these adjustments account for approximately 82% of the distribution and other expense category shown in Illustration No. 2.

Q. Please describe the remaining column in Illustration No. 2 above, labeled DSM/Retail Revenue Credit Adjustments.

A. This component of Illustration No. 2 above represents the impact of two specific adjustments included in the Company's filing related to an earnings deficiency impacting the Company. Company witnesses Mr. Norwood and Mr. Ehrbar, discuss the impact of the Demand Side Management (DSM) programs to assisting our customers with electric energy efficiency. The impact of these efforts serves to increase expense by approximately $4 million (revenue requirement of $4.2 million).

Second, as discussed by Mr. Johnson and sponsored by Company witness Ms. Knox, is the Retail Revenue Credit pro forma adjustment, increasing the Company's production and transmission operating expenses by approximately $3.5 million. Due to the way the existing retail revenue credit is calculated, a shortfall occurs in the rate year because too much retail revenue has been used to offset variable power costs in the ERM deferral calculation. Therefore, new revenue from load growth is not available to offset costs associated with capital additions that are necessary to replace aging production, transmission, and back-bone distribution infrastructure, or increased operation and maintenance expenses.

Revenue Requirement

Q. Would you please explain what is shown on page 1 of Exhibit No._____(EMA-2)?

A. Yes. Exhibit No._____(EMA-2) shows actual and pro forma electric operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No.____(EMA-2) shows 2011 actual operating results and components of the average-of-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is the pro forma and attrition adjusted results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn an 8.25% rate of return. Column (f) reflects total pro forma and attrition-adjusted electric operating results with the requested increase of $40,983,000.

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

A. Yes. Page 2 shows the calculation of the $40,983,000 revenue requirement at the requested 8.25% rate of return.

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

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital 8.25%. Company witness Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Company witness Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

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

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

Q. Now turning to pages 5 through 11 of your Exhibit No._____(EMA-2), would you please explain what those pages show?

A. Yes. Page 5 begins with actual operating results and rate base for the 2011 test period in column (1.00). Individual normalizing and restating adjustments that are standard components of our annual reporting to the Commission begin in column (1.01) on page 5 and continue through column (2.17) on page 7. Individual pro forma adjustments are shown on page 8 in columns (3.00) though (3.07). The restating and pro forma adjustments are shown in columns *(1.01)* through *(3.07),* of pages 5 through 8 of Exhibit No._____(EMA-2).

Additional columns (4.00) through (4.03) on page 9 of Exhibit No._____(EMA-2), represent my alternative analysis serving as a “cross-check” to the Attrition Adjustment sponsored by Company witness Dr. Lowry. The final column labeled “Attrition Adjusted Total” represents the attrition-adjusted sub-total capturing the effect of previously-discussed pro forma adjustments as well as Dr. Lowry’s Attrition Adjustment. The final columns, shown on page 10 of Exhibit No._____(EMA-2), (4.04) through (4.06) are final pro forma adjustments necessary to restate the attrition-adjusted sub-total for known offsets that are outside the attrition-adjusted revenue requirement proposed in this case.

Each of these adjustments are discussed further in the testimony that follows, and the Company has also provided workpapers, both in hard copy and electronic formats, outlining additional details related to each of the adjustments or components.

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

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

A. Yes, but before I begin, I will note a few changes made to the **Results of Operations** column (1.00), reflecting the Company’s actual electric operating results and rate base.

In past general electric (and natural gas) rate case filings based on past Commission orders, this column represented actual net operating income and net utility plant, which included balances after accumulated depreciation and amortization, but before accumulated deferred income taxes (DFIT) and other rate base adjustments impacting the Company's actual net rate base results. Accumulated DFIT and other rate base adjustments were included as "Standard Commission Basis and Restating Adjustments" to be consistent with prior Commission orders, resulting in a "Restated Total" provided within the Company's filing.

In this filing however, column (1.00) Results of Operations reflects the actual operating results and total net rate base experienced by the Company for 2011 on an average-of-monthly-average (AMA) basis, including Accumulated DFIT and other rate base adjustments previously shown as restating adjustments. Columns following the Results of Operations column (1.00) reflect restating adjustments necessary to: restate the actual results based on prior Commission orders; reflect appropriate annualized expenses; correct for errors; or remove prior period amounts reflected in the actual 2011 results.

Q. Please continue with your explanation of each adjustment and its effect on test period net operating income and/or rate base?

A. The first adjustment, column (1.01) on page 5, entitled **Deferred FIT Rate Base**, adjusts the DFIT rate base balance included in the Results of Operations column (1.00) to the corrected DFIT balance, as shown within my workpapers provided with the Company's filing. Accumulated DFIT reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery System, or ACRS, and Modified

Accelerated Cost Recovery, or MACRS) and bond refinancing premiums. These amounts are reflected on the average-of-monthly-average balance basis. The effect on Washington rate base for this correction is an increase of $285,000. An increase to Washington net operating income of $3,000 is due to the Federal income tax (FIT) expense on the restated level of interest on the change in rate base[4].

The adjustment in column (1.02), **Deferred Debits and Credits,** is a consolidation of previous Commission Basis or other restating rate base adjustments and their net operating income (NOI) impact. The net impact on a consolidated basis of this adjustment decreases Washington rate base by $7,013,000. Washington net operating income (NOI) decreases by a total of $84,000; including reductions to operating income of $120,000 for expenses, and $73,000 of FIT expense related to the restated level of interest on the change in rate base, and an increase in operating income for FIT expense of $109,000.

As noted above, the 2011 AMA actual rate base amounts of other rate base adjustments are included in the Results of Operations column (1.00). Adjustments included in the Deferred Debits and Credits consolidated adjustment are those necessary to reflect restatements from actual results based on prior Commission orders, and are explained below. For consistency with prior rate case filings, a description of each previously separated adjustment is included below.

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[4] An additional change the Company has made from prior filings, is that the net effect of Federal income tax (FIT) expense on the restated level of interest expense due to a change in rate base, is shown within <u>each</u> individual adjustment, rather than as a consolidated adjustment previously included in the Company's "Restate Debt Interest" adjustment. The restated debt interest impact per individual adjustment can be seen on Line 27 of Exhibit No. EMA __(EMA-2). As discussed later in my testimony, the "Restate Debt Interest" adjustment restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies, on the Results of Operations level of rate base shown in column (1.00) only, resulting in a revised level of tax deductible interest expense on actual test period rate base.

The following items are included in the consolidation:

- **Gain on Office Building** reflects the removal of the amortization expense and AMA rate base balance included in the Company's 2011 test period related to Washington's portion of the amortized gain on the sale of the Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period ending in 2011. The average-of-monthly-averages (AMA) amount of the deferred gain for the 2013 rate period is zero. The use of AMA for the rate period was ordered in Order No. 01 in Docket No. U-071805. The effect on Washington rate base is an increase of approximately $43,000. The effect on Washington operating income is a decrease of approximately $131,000.
- **Colstrip 3 AFUDC Elimination** reflects the reallocation of rate base and depreciation expense between jurisdictions. In Cause Nos. U-81-15 and U-82-10, the UTC allowed the Company a return on a portion of Colstrip Unit 3 construction work in progress ("CWIP"). A much smaller amount of Colstrip Unit 3 CWIP was allowed in rate base in Case U-1008-144 by the Idaho Public Utilities Commission ("IPUC"). The Company eliminated the AFUDC associated with the portion of CWIP allowed in rate base in each jurisdiction. Since production facilities are allocated on the Production/Transmission formula, the allocation of AFUDC is reversed and a direct assignment is made. The rate base adjustment reflects the average-of-monthly-averages amount for the test period. There is no adjustment necessary for the effect of the reallocation on Washington rate base, as the appropriate amount is accurately reflected in the results of operations column. The effect on Washington operating income is an increase of $191,000.
- **Colstrip Common AFUDC** is associated with the Colstrip plants in Montana, and impacts rate base. Differing amounts of Colstrip common facilities were excluded from rate base by this Commission and the IPUC until Colstrip Unit 4 was placed in service. The Company was allowed to accrue AFUDC on the Colstrip common facilities during the time that they were excluded from rate base. It is necessary to directly assign the AFUDC because of the differing amounts of common facilities excluded from rate base by this Commission and the IPUC. In September 1988, an entry was made to comply with a Federal Energy Regulatory Commission ("FERC") Audit Exception, which transferred Colstrip common AFUDC from the plant accounts to Account 186. These amounts reflect a direct assignment of rate base for the appropriate average-of-monthly-averages amounts of Colstrip common AFUDC to the Washington and Idaho jurisdictions. Amortization expense associated with the Colstrip common AFUDC is charged directly to the Washington and Idaho jurisdictions through Account 406 and is a component of the actual results of operations. The rate base amount is also included in the results of operations accurately reflecting the average-of-monthly-averages amount for the test period. No adjustment is necessary.

- **<u>Kettle Falls Disallowance</u>** reflects the Kettle Falls generating plant disallowance ordered by this Commission in Cause No. U-83-26. The disallowed investment and related depreciation, FIT expense, accumulated depreciation and accumulated deferred FIT on an AMA basis are accurately reflected in the results of operations column, removing these amounts from actual results of operations. No adjustment is necessary.
- **<u>Settlement Exchange Power</u>** reflects the rate base associated with the recovery of 64.1% of the Company's investment in Settlement Exchange Power. The 64.1% recovery level was approved by the Commission's Second Supplemental Order in Cause No. U-86-99 dated February 24, 1987. Amortization expense and deferred FIT expense recorded during the test period are accurately reflected in results of operations. However, the production rate base and accumulated deferred FIT amounts within results of operations are reflected on an AMA 2011 test period basis. The use of AMA for the rate period was ordered in Order No. 01 in Docket No. U-071805. To adjust the production rate base and accumulated deferred FIT amounts to reflect an AMA 2013 rate period basis, the effect on Washington rate base is a decrease of $4,019,000.
- **<u>Restating CDA Settlement Deferral</u>** adjusts the net assets and DFIT balances reflected in results of operations associated with the 2008/2009 past storage and §10(e) charges deferred for future recovery, to a 2013 AMA basis. A ten-year amortization expense, as approved in Docket No. UE-100467, of the CDA Settlement Deferral is accurately reflected in results of operations. The effect on Washington rate base is a decrease of $198,000.
- **<u>Restating CDA/SRR (Spokane River Relicensing) CDR Deferral</u>** adjusts the net assets and DFIT balances reflected in results of operations associated with the CDA Tribe settlement 4(e) Spokane River relicensing conditions deferred for future recovery, to a 2013 AMA basis. A ten-year amortization expense of the CDA/SRR CDR Deferral, as approved in Docket No. UE-100467 is accurately reflected in results of operations. The effect on Washington rate base is a decrease of $14,000.
- **<u>Restating Spokane River Deferral</u>** adjusts the net asset and DFIT balances reflected in results of operations related to the Spokane River deferred relicensing costs deferred for future recovery, to a 2013 AMA basis. A ten-year amortization expense of the Spokane River Deferral, as approved in Docket No. UE-100467 is accurately reflected in results of operations. The effect on Washington rate base is a decrease of $95,000.
- **<u>Restating Spokane River PM&E Deferral</u>** adjusts the net asset and DFIT balances reflected in results of operations related to the Spokane River deferred PM&E costs deferred for future recovery, to a 2013 AMA basis. A ten-year amortization expense of the Spokane River PM&E Deferral, as approved in Docket No. UE-100467 is accurately reflected in results of operations. The effect on Washington rate base is a decrease of $60,000.
- **<u>Restating Montana Riverbed Lease</u>** adjusts the net asset and DFIT balances reflected in results of operations related to the costs associated with the Montana Riverbed lease settlement deferred for future recovery, to a 2013 AMA basis. In the

Montana Riverbed lease settlement, the Company agreed to pay the State of Montana $4.0 million annually beginning in 2007, with annual inflation adjustments, for a 10-year period for leasing the riverbed under the Noxon Rapids Project and the Montana portion of the Cabinet Gorge Project. The first two annual payments were deferred by Avista as approved in Docket No. UE-072131. In Docket No. UE-080416 (see Order No. 08), the Commission approved the Company's accounting treatment of the deferred payments, including accrued interest, to be amortized over the remaining eight years of the agreement starting on January 1, 2009. This restating adjustment also includes the increase in the annual lease payment expense for the additional annual inflation. This adjustment decreases Washington operating income by $176,000 and decreases rate base by $880,000.

- **Restating Lancaster Amortization** adjusts the net asset and DFIT balances reflected in results of operations related to the 2010 ($6.8 million Washington) deferred Lancaster plant Power Purchase Agreement (PPA), to a 2013 AMA basis. A five-year amortization expense of the Lancaster deferral, as approved in Docket No. UE-100467 is accurately reflected in results of operations. The effect on Washington rate base is a decrease of $1,768,000.
- **Customer Advances** decreases rate base for money advanced by customers for line extensions, as they will be recorded as contributions in aid of construction at some future time. The reduction to rate base per results of operations is $248,000. The correct amount is $270,000. A reduction to Washington rate base of $22,000 is necessary to properly reflect the removal of customer advances.
- **Customer Deposits** reduces electric rate base by the average-of-monthly-averages of customer deposits held by the Company, as ordered by this Commission in Docket UE-090134. The reduction to rate base per results of operations is accurately reflected at approximately $3,743,000; therefore no adjustment is necessary to rate base. The corresponding interest paid on customer deposits is reclassified to utility operating expense, at the current UTC interest rate of 0.26%. The effect on Washington operating income is a decrease of $4,000.

In summary, as noted above, the net impact on a consolidated basis of the adjustments described above decreases Washington net operating income by $84,000, and decreases Washington rate base by $7,013,000.

Q. Please continue describing the remaining adjustments on page 5.

A. The adjustment in column (1.03), **Working Capital**, adjusts the working capital balance reflected in the Company's Results of Operations column (1.00), to the corrected working capital balance described below.

The amount of working capital reflected in results of operations is the amount of Investor Supplied Working Capital (ISWC) approved in Docket No. UE-100467 of $18,188,000. The corrected ISWC amount based on a 2011 AMA basis is $31,877,000, an increase of $13.7 million.

Although there are various appropriate methods used to determine a Company's working capital, to reduce the issues in this case[5], the Company has calculated its working capital in this proceeding using the ISWC method. This calculation was computed based on the Company's understanding of the ISWC methodology discussed by Staff in Docket No. UE-100467. Although neither the method nor the calculation were agreed to during that proceeding, the parties accepted, for settlement purposes, the $18.2 million amount for working capital recommended by Staff that uses the ISWC method[6]. This method is consistent with that used in the Company's most recent electric general rate case, Docket No. UE-110876. However, the Settlement approved in that docket did not specify the amount of working capital included in rate base, nor the method approved. The effect on Washington rate base is an increase of $13,689,000. An increase to Washington net operating income of $142,000 is due to the FIT expense of the restated level of interest on the change in rate base.

The next adjustment, included after Working Capital, is labeled column (2.01), **Eliminate B & O Taxes**, and eliminates the revenues and expenses associated with local business and occupation (B & O) taxes, which the Company passes through to its

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[5] The Company, of course, reserves the right to argue a different methodology in a future proceeding if appropriate.

[6] The Commission also approved a similar ISWC approach in Docket No. UE-100749, Washington Utilities and Transportation Commission v. PacifiCorp D/B/A Pacific Power & Light Company.

Washington customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $46,000.

The adjustment in column (2.02), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to decrease Washington net operating income by $206,000.

The last adjustment on page 5, shown in column (2.03), **Regulatory Expense**, restates recorded 2011 regulatory expense to reflect the UTC assessment rates applied to revenues for the test period and the actual levels of FERC fees paid during the test period. The effect of this adjustment is a decrease to Washington net operating income of $31,000.

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

A. Page 6 starts with the adjustment shown in column (2.04), **Injuries and Damages**, which is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to increase Washington net operating income by $150,000.

The adjustment in column (2.05), **FIT/DFIT/ITC/PTC Expenses**, adjusts the FIT and DFIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items, matching the jurisdictional allocation of other Schedule M items to related Results of Operations allocations and adjusts the appropriate level of production tax credits and investment tax credits on qualified generation.

The net FIT and production tax credit adjustments increases Washington net operating income by $127,000. Adjusting for the proper level of deferred tax expense for the test period decreases Washington net operating income by $147,000. This adjustment also reflects the proper level of amortized investment tax credit for the test period increasing Washington net operating income by an additional $15,000. Therefore, the net effect of this adjustment, all based upon a Federal tax rate of 35%, is to decrease Washington net operating income by $5,000.

The adjustment in column (2.06), **Eliminate WA ERM Surcharge & Deferrals**, removes the effects of the financial accounting for the Energy Recovery Mechanism (ERM.) The ERM normalizes and defers certain net power supply and transmission revenues and costs pursuant to the commission-approved deferral and recovery mechanism. The adjustment removes the ERM surcharge revenue as well as the deferral and amortization amounts and certain directly assigned power costs and net transmission costs associated with the ERM. The effect of this adjustment is to increase Washington net operating income by $8,312,000.

The adjustment in column (2.07), **Nez Perce Settlement Adjustment**, reflects an increase in production operating expenses. An agreement was entered into between the Company and the Nez Perce Tribe in 1999 to settle certain issues regarding earlier owned and operated hydroelectric generating facilities of the Company. This adjustment directly assigns the Nez Perce Settlement expenses to the Washington and Idaho jurisdictions. This is necessary due to differing regulatory treatment in Idaho Case No. WWP-E-98-11 and Washington Docket No. UE-991606. This restating adjustment is consistent with Docket No. UE-011595. The effect of this adjustment is to decrease Washington net operating income by $9,000.

The adjustment in column (2.08), **Eliminate A/R Expenses**, removes expenses incurred associated with the fees charged the Company for its customer accounts receivable program included in the test period. The Company's accounts receivable program was terminated in December of 2010. The effect of this adjustment is to increase Washington net operating income by $1,000. This adjustment will be removed from future rate case proceedings.

The adjustment in column (2.09), **Office Space Charged to Subsidiaries**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T. The effect of this adjustment is to increase Washington net operating income by $3,000.

The last adjustment on page 6 is included column (2.10), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to increase Washington net operating income by $67,000.

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

A. Page 7 starts with the adjustment in column (2.11), **Net Gains/Losses**, which reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 2002 and 2011. This restating adjustment is made as a result of the Commission's Order in Docket No. UE-050482. The effect of this adjustment is to increase Washington net operating income by $52,000.

The adjustment in column (2.12), **Revenue Normalization**, is an adjustment taking into account known and measurable changes that include revenue repricing (including the current authorized rates approved in Docket No. UE-110876), weather normalization and a recalculation of unbilled revenue. Revenues associated with the Schedule 91 Tariff Rider and Schedule 59 Residential Exchange are excluded from pro forma revenues, and the related amortization expense is eliminated as well. Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $10,116,000.

The adjustment in column (2.13), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, dues and donations, etc., included in error in the test period actual results, and removes or restates other expenses incorrectly charged between service and or jurisdiction totaling approximately $23,000[7]. I describe further the process for removing or restating certain

[7] As discussed later in my testimony, additional changes in A&G expense due to errors discovered during the process of the Company's internal audit of accounting practices and subsequent review by Rates Department personnel for similar transactions, would have the effect of reducing electric A&G expense by approximately $3,300.00 and increasing natural gas A&G expense by approximately $2,500.00. The corrections to electric and natural gas expense were found after the completion of the Company's revenue requirement filed in this case and should be adjusted in the final revenue requirement received in this proceeding.

expenses from the Company's test period in Section VI (Compliance with Commission Order No. 6, Docket Nos. UE-110876 & UG-110877) discussed below.

The Company also removed 50% of director meeting expenses, as ordered in Docket No. UE-090134, and 10% of director fees totaling approximately $67,000. The effect of this adjustment is to increase Washington net operating income by $59,000.

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

A. In 2012, the Company requested each of its Directors, based on their actual experience, to estimate the time they append spend on utility versus non-utility duties and responsibilities. The responses from the Directors indicated that, in the aggregate, approximately 90% of the Directors' time is dedicated to utility matters, and approximately 10% to non-utility.

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

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

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

This Commission, as shown above, has recognized that D&O insurance is part of the "compensation package" (splitting such costs on a 90/10 basis). Similarly, Directors' fees, like D&O insurance referred to above, are a part of the Directors' compensation package offered to attract and retain qualified Directors. Based on the actual time dedicated to the utility, a 90/10 sharing should be applied to Directors' fees. Director fees paid to board members for their duties specific to other Avista boards, i.e. Ecova, are otherwise charged 100% to non-utility. Using a 90/10 sharing for the remaining Director fees paid for participating in Avista Corp./Utility board meetings, reduced the Company's expense included in this filing by approximately $28,000.

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

A. The adjustment in column (2.14), **PCB Transformer Restating**, removes the prior period costs associated with the PCB transformer system testing removal project, previously recorded as cost of removal during the periods 2007-2011, later expensed in the 2011 test period. This adjustment also includes a proposed three-year amortization (2013-2015) of these expenses.

In 2007, Avista initiated a field testing program to perform a comprehensive accelerated identification and removal of all PCB-tainted transformers as part of an overall asset management program. Upon initiation of the identification program, these costs were capitalized as Cost of Removal (FERC account 108). Past experience had indicated 10% of unidentified transformers would contain PCBs and therefore be scheduled for removal. Completion of the field testing in 2011 performed for PCB identification resulted in no transformers identified as needing removal. The Company believes it is appropriate to recover these costs, and proposes a three-year amortization of these expenses. The effect of this adjustment increases Washington net operating income by $554,000.

The adjustment in column (2.15), **Restating Incentives,** restates the actual incentives included in the Company's test period using a six-year average adjusted by the Consumer Price Index. I discuss further in Section V (Appropriateness & Normalization of Incentive Costs) the basis for the use of a six-year average. The effect of this adjustment is to decrease Washington net operating income by $487,000.

The adjustment in column (2.16), **Colstrip/CS2 Maintenance**, includes $981,000 of deferred maintenance expense expected in 2013, which equates to ¼ of the deferred maintenance expense recorded in 2011 and 2012, to be amortized over four years. See Section VI (Compliance with Commission Order No. 6, Docket Nos. UE-110876 & UG-110877), for further explanation. The effect of this adjustment is to decrease Washington net operating income by $638,000.

The adjustment in column (2.17), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies, on the Results of Operations level of rate base shown in column (1.00) only, resulting in a revised level of tax deductible interest expense on actual test period rate base. The Federal income tax effect of the restated level of interest for the test period increases Washington net operating income by $126,000.

The Federal income tax effect of the restated level of interest on all other rate base adjustments included in the Company's filing are included and shown as an income impact of each individual rate base adjustment described elsewhere in this testimony.

The last column on page 7, entitled **Restated Total**, subtotals all the preceding columns (1.00) through column (2.17). These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports, except power supply[8].

Pro Forma Adjustments

Q. Please explain the significance of the 8 columns beginning at page 8 on your Exhibit No.____(EMA-2).

A. The adjustments shown on page 8 of Exhibit No. ___(EMA-2) are pro forma adjustments that recognize the jurisdictional impacts of items that will impact the pro forma operating period for known and measurable changes. They encompass revenue and expense items as well as additional capital projects. These adjustments bring the operating results and rate base to the pro forma sub-total level for the test year.

Q. Please explain each of the pro forma adjustments shown on page 8.

A. The adjustment in column (3.00), **Pro Forma Power Supply**, was made under the direction of Mr. Johnson and is explained in detail in his testimony. This adjustment includes pro forma power supply related revenue and expenses to reflect the

[8] The restated total also includes an increase in expense necessary to annualize certain 2011 expenses included in the test period as restating adjustments, (i.e. Colstrip/CS2 maintenance) and includes an increase to expense for a 6-year average of incentives.

twelve-month period January 1, 2013 through December 31, 2013, using historical loads. Mr. Johnson's testimony outlines the system level of pro forma power supply revenues and expenses that are included in this adjustment. This adjustment calculates the Washington jurisdictional share of those figures, and also eliminates an offsetting direct assignment of certain power supply costs included in the base Results of Operations. The net effect of the power supply adjustments decrease Washington net operating income by $5,238,000.

The adjustment in column (3.01), **Pro Forma Transmission Rev/Exp,** was made under the direction of Mr. Kinney and is explained in detail in his testimony. This adjustment includes pro forma transmission-related revenues and expenses to reflect the twelve-month period January 1, 2013 through December 31, 2013. The net effect of the transmission revenue and expense adjustments decrease Washington net operating income by $526,000.

The adjustment in column (3.02), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in adjustment (3.03). For non-union employees, test period wages and salaries are restated to include the March 2012 overall actual increase of 3.0%, and 10 months of the planned March 2013 increase of 2.5%. Ms. Feltes discusses the Company's overall compensation plan and notes that the 2.5% minimum increase will be presented to the Compensation Committee of the Board of Directors for approval at the Board's May 2012 meeting.

Also included in this adjustment are the 2012 and 2013 union contract increases agreed to in 2010 of 3.0% for both years. The methodology behind this adjustment is consistent with that used in the Company's previous Docket No. UE-110876. The effect of this adjustment on Washington net operating income is a decrease of $1,370,000.

The adjustment in column (3.03), **Pro Forma Labor-Executive**, reflects known and measurable changes to allocated executive officer salaries, which have been updated for new utility and non-utility percentages, reducing the executive compensation expense included in the Company's 2011 historical test period. No additional increases in executive labor expenses have been included in this filing.

Based on information received from each executive officer, base salaries are allocated between utility and non-utility operations. Annually, each executive officer determines the amount of their individual time to be allocated. This allocation is based on actual experience, adjusted for any known changes for the upcoming year. The average for 2011 allocation was approximately 91% utility and 9% non-utility. While there have been no changes to the executive officers salaries in this filing, the weighting of utility/non-utility has been updated to be approximately 87% utility and 13% non-utility.

Ms. Feltes discusses at length Company executive compensation, and includes in Exhibit Nos.__(KSF-C) and (KSF-2C), the Executive Officer Compensation report filed on February 28, 2012, in compliance with the Order in the last general rate cases (Docket Nos. UE-110876 and UG-110877), providing support for the level of executive compensation included in the Company's filing. The impact of this adjustment on Washington net operating income is a slight increase of $8,000.

The adjustment in column (3.04), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense, decreasing Washington net operating income by $2,144,000.

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

A. As discussed by Ms. Feltes, the Company's pension expense portion of this adjustment is determined in accordance with Accounting Standard Codification 715 (ASC-715), and has increased on a system basis from approximately $21.9 million for the actual test year costs for the twelve months ended December 31, 2011, to $27.0 million for 2012. The increase in pension <u>expense</u> ($1.6 million Washington electric) is primarily due to a decrease in the discount rate used in calculating the pension expense and liability as well as a decrease in the expected return on assets and changes in other actuarial assumptions that are not predictable. At this time the amounts included in this case are based on the most current available data. Preliminary pension expense is determined by an outside actuarial firm, in accordance with ASC-715, and provided to the Company late in the first quarter of each year. These calculations and assumptions are reviewed by the Company's outside accounting firm annually for reasonableness and comparability to other companies. Due to the timing of this report, additional information may become known during the course of these proceedings that may require a modification to this adjustment.

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

A. The Company's medical insurance and post-retirement expense portion of this adjustment ($1.69 million Washington electric) adjusts for the medical-related costs planned for 2012 above the test period. As discussed by Ms. Feltes, medical insurance and post-retirement expense has increased on a system basis from $25.26 million for the actual test year costs for the twelve months ended December 31, 2011, to $30.59 million for 2012. In recent years, the Company has experienced increasing ASC 715 expense. ASC 715 requires employers to recognize the cost of providing post-retirement benefits on an accrual basis. The cost must be recognized during the working years of the employees to full eligibility date. Most of the increase in ASC 715 expense can be explained by declining interest rates, lower than expected investment returns, and greater amortization expense due to changes in the valuation of the actuarial liability.

Ms. Feltes discusses the measures taken by the Company to mitigate the increases in pension and medical related expenses. The net impact of the increases in pension and medical costs is an increase in Washington electric expense of approximately $3.3 million.

The adjustment in column (3.05), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2012. Costs of system-wide insurance policies for 2012 have decreased slightly from those policies in 2011 (just over $100,000 decrease in expense). Insurance costs that are properly charged to non-utility operations have been excluded from this adjustment. In addition, Avista has removed a total of 10% of the total Directors' and Officers' insurance expense as ordered in Docket No. UE-090134. This adjustment increases Washington net operating income by $66,000.

The adjustment in column (3.06), **Pro Forma Property Tax**, restates the 2011 test period accrued level of property taxes expense to the 2013 rate period level. As can be seen from my workpapers provided with the Company's filing, the property on which the tax is calculated is the property value as of December 31, 2012, reflecting the 2013 level of expense the Company will experience during the rate period. The effect of this adjustment decreases Washington net operating income by $1,303,000.

Q. With regards to the property tax expense included in the 2011 historical test period, at what date is the property value used to determine the property tax assessed based on?

A. The tax basis for the 2011 historical test period expense is based on plant balances as of December 31, 2010.

Q. What does this mean for ratemaking purposes and the impact of property tax expense in this case?

A. The property tax expense that appears in the test period in this case is understated for ratemaking purposes, because it only captures the property taxes on property owned by the Company at December 31, 2010. For ratemaking purposes, this filing must capture the property tax associated with all property that will be assessed property taxes during the rate year. A property tax that captures only property owned on December 31, 2010 will not serve to match costs with benefits.

Q. How has Avista calculated its property tax adjustment in this filing?

A. The Company's pro forma property tax calculation captures all assets owned on December 31, 2012. This adjustment is necessary, because the test year level of property tax expense represents an understated estimate of the property taxes associated with the rate year for two reasons. First, the test year does not include any actual additions to plant for 2011 or 2012. These additions are the basis for the actual expenses the Company will incur in 2013. Second, the methodology used to produce the tax value included in the historical test year violates the matching principle, because it fails to match the costs in the rate year with the benefits derived from the assets owned during the rate year.

Q. Can you summarize how Avista has calculated the property tax expense included in this filing?

A. The system tax basis was determined by using the actual tax basis used to compute the 2011 test period property tax expense, which was the net book value of Company owned property as of December 31, 2010. This amount was increased approximately $119 million[9], to reflect actual plant additions for 2011, net of 2011 actual depreciation expense. In addition, the tax basis was increased by approximately $159 million to reflect 2012 plant additions and depreciation expense. The most current tax rates were applied to this computed tax basis to determine the 2013 property tax expense. The effect of this adjustment decreases Washington net operating income by $1,303,000.

Q. Please continue with your discussion of the pro forma adjustments included on page 8 of Exhibit No. __(EMA-2).

A. The last pro forma adjustment shown on page 8 is included in column (3.07), **Restating 2011 Capital.** This adjustment restates plant additions included in the test year

[9] The increase in tax basis for 2011 is consistent with the change to system net plant rate base as shown on the Company's Results of Operations reports.

on an AMA basis to an end of period basis, together with the associated accumulated depreciation and deferred federal income taxes at a 2011 end of period basis, as described further by Mr. DeFelice. This adjustment also includes the annual level of associated depreciation expense on all plant-in-service at December 31, 2011.[10] The effect of this adjustment on Washington net operating income is a decrease of $779,000. The effect on Washington rate base is an increase of $30,915,000.

Q. Turning to page 9 of Exhibit No. __(EMA-2), what is shown in the first column on that page?

A. The first column on page 9, labeled Pro Forma Sub-Total, reflects total pro forma results of operations and rate base consisting of test period actual results (twelve-months ending December 31, 2011) and the total of all restating and pro forma rate case adjustments to the historical test period.

Q. At this point, what does the Pro Forma total column show is the revenue requirement need for Avista?

A. As can be seen on Line 50, Column Pro Forma Sub-Total, Page 9 of Exhibit No. __(EMA-2), the revenue requirement up to this point (including all previously-discussed restating and pro forma rate case adjustments to the historical test period) shows a revenue shortfall or revenue requirement of $20.988 million. As explained below, however, after

[10] As noted by Staff witness Mr. Elgin in his recent testimony in the PSE rate case (Docket Nos. UE-111048 and UG-111049), Exhibit No. KLE-1T, pp. 65-66, the Commission has, under certain circumstances, accepted end-of-period balances for rate base to address growing investments, rising costs and regulatory lag. (See WUTC v. Washington Natural Gas Co., Cause No. U-80-111). He also referred to language from an earlier Order for Puget Sound Power & Light which, while rejecting year-end rate base, provided that, "[The Commission] has not, however, discounted the validity of year-end rate base where special conditions exist, such as unusual growth in plant at a faster pace than customer growth and customary rate making is deficient." (See WUTC v. Puget Sound Power & Light Co., Cause No. U-73-57, 6th Supp. Order at 9 (Oct. 25, 1974).)

further taking into account Dr. Lowry's Attrition Adjustment of $20.5 million, the total revenue requirement, adjusted for attrition is $41.502 million, as shown in Column AA-Ttl, Line 50.

Q. Please explain the significance of the 5 columns shown on page 9 of your Exhibit No.____(EMA-2), beginning after the Pro Forma Sub-Total column.

A. The four columns immediately after the Pro Forma Sub-Total column on page 9 represent my own alternative analysis of the attrition impact of the planned capital expenditures for 2012 and 2013, as well as the impact of the DSM program referred to by Mr. Ehrbar. The final column of page 9, entitled Attrition Adjusted Total, equating to $41.502 million, is the revenue requirement, including the impact of Dr. Lowry's attrition adjustment that was actually used for purposes of developing the revenue requirement, and as described further within his direct testimony[11].

Company witnesses Mr. Norwood and Dr. Lowry discuss further the significance of the attrition-adjusted revenue requirement amount within their testimonies, and the independent Attrition Study performed by Dr. Lowry.

As mentioned above, as a "cross-check" on the reasonableness of Dr. Lowry's overall attrition-adjusted revenue requirement during the 2013 rate year of $41.502 million, I have also analyzed the effect of growth in rate base and impact of DSM through the 2013 rate period. First, however, as described above, I have started with the unadjusted results of

[11] See Dr. Lowry's total revenue requirement deficiency of $41.502 million at Exhibit No.__(MNL-5), Column [J], Line 56.

operations for 2011 and prepared specific restating and pro forma adjustments resulting in a revenue shortfall or revenue requirement of $20.988 million[12].

Next, I isolated the impact of planned capital additions in 2012 and 2013 that will be in place during the period that new retail rates will be in effect (essentially the 2013 calendar year). I have also included the impact of the DSM program, and finally, included an amount to tie to the total Attrition Adjustment of Dr. Lowry. These components are described briefly below, and additional details are provided by other Company witnesses.

Q. Please briefly explain each of the components included on page 9 of Exhibit No. __(EMA-2).

A. The first component included in column (4.00), **Planned Capital Additions 2012**, reflects all 2012 capital additions (excluding distribution-related capital expenditures made that are associated with connecting new customers to the Company's system) together with the associated accumulated depreciation and deferred federal income taxes at a 2012 EOP basis. This component also includes associated depreciation expense for these planned additions. In addition, the plant-in-service at December 31, 2011, was adjusted to a 2012 EOP basis. Mr. DeFelice describes this component in detail within his testimony. The effect of this component would have decreased Washington net operating income by $3,968,000 and increased rate base by $63,456,000.

The second component included in column (4.01) **Planned Capital Additions 2013**, reflects all 2013 capital additions (excluding distribution-related capital expenditures made

[12] Subtracting from Dr. Lowry's overall revenue requirement on an attrition-adjusted basis of $41.502 million, the $20.988 million noted above representing the pro forma adjusted sub-total, isolates the attrition portion of his adjustment totaling $20.514 million.

that are associated with connecting new customers to the Company's system) together with the associated accumulated depreciation and deferred federal income taxes at a 2013 AMA basis. This component included associated depreciation expense for the planned additions. In addition, the plant-in-service at December 31, 2012 was adjusted to a 2013 AMA basis. Mr. DeFelice also describes this component in detail within his testimony. The effect of this component would have decreased Washington net operating income by $1,098,000 and decreased rate base by $2,618,000.

The third component is included in column (4.02), labeled **DSM.** As discussed further by Mr. Norwood, and sponsored by Mr. Ehrbar, one of the reasons Avista is experiencing attrition is due to our success in assisting our customers with electric energy efficiency through our DSM programs. Mr. Ehrbar quantifies how much of Avista’s attrition problem is being caused by electric energy savings through DSM, which is included in this component. The effect of this component would have decreased Washington net operating income by $2,585,000.

The fourth and final component is included in column (4.03), labeled **Other,** which records the additional expense ($100,000) necessary to equate with the total level of attrition deficiency as determined by Dr. Lowry’s Attrition Study, and as discussed further within his testimony. The effect of this component would decrease Washington net operating income by $65,000.

Remaining Pro Forma Adjustments

Q. Starting in the first column on the last page of Exhibit No. __(EMA-2), page 10, there are three final adjustments and a total column, could you please explain the purpose of these adjustments.

A. Yes. The final three adjustments included on page 10, are necessary to restate the attrition-adjusted total shown on page 9, line 50, of $41.502 million to the **Final Total,** producing the revenue requirement requested in this case of $40.983 million. These three adjustments were necessary to include after the attrition-adjusted total because they reflect necessary adjustments to pro forma or attrition-adjusted results for known offsets that are outside of the Attrition Adjustment provided by Dr. Lowry.

Q. Please describe the individual adjustments shown on page 10.

A. The first adjustment in column (4.04), labeled **Retail Revenue Credit,** is discussed by Mr. Johnson, and sponsored by Ms. Knox. As described by Mr. Johnson, the existing retail revenue credit rate, which is based on the fixed and variable production and transmission costs, is set too high. When retail loads increase, too much new revenue is credited back to customers through the ERM, rather than being available to offset increased costs. Because too much revenue is credited back to customers through the ERM, the matching principle is violated following a general rate case. New revenue from load growth is not available to offset costs associated with capital additions that are necessary to replace aging production, transmission, and back-bone distribution infrastructure, or increased operation and maintenance expenses. As described by Ms. Knox, this adjustment identifies the cost of that excess deferral credit in 2013 if the existing method is continued, rather than the proposed method. This adjustment would be excluded if the proposed method for determining the retail revenue credit rate, as discussed by Mr. Johnson, is adopted.

The effect of this adjustment on Washington net operating income is a decrease of $2,255,000.

The adjustment included in Column (4.05), **Depreciation Study,** as discussed by Mr. DeFelice, reflects the Company's proposed changes in depreciation rates pertaining to electric plant-in-service using the recently completed depreciation study performed by Gannett Fleming, Inc. Additional workpapers including the detailed Depreciation Study prepared by Gannett Fleming, Inc. are included with Mr. DeFelice's workpapers included with the Company's filing. The effect of this adjustment on Washington net operating income is an increase of $1,944,000.

The final adjustment column is (4.06), **O&M Offsets**. As explained by Mr. DeFelice, all of the 2012 and 2013 capital additions were reviewed for any O&M offsets that were expected in the 2013 rate period. Any specific offset that was identified, was included as a reduction to O&M costs and discussed in Mr. Kinney, Mr. Lafferty and Mr. DeFelice's direct testimonies with the capital asset with which the offset relates. The effect of this adjustment on Washington net operating income is an increase of $634,000.

Revenue Requirement Summary

Q. Referring back to page 1, line 49, of Exhibit No._____(EMA-2), what was the actual and pro forma electric rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 6.76%. The pro forma rate of return is 6.17% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.25% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington electric operations to allow the Company an opportunity to earn its proposed 8.25% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $25,443,000, as shown on line 5, page 2 of Exhibit No._____(EMA-2). The resulting revenue requirement is shown on line 7 and amounts to $40,983,000, or an increase of 9.01% over pro forma general business revenues.

IV. NATURAL GAS SECTION

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

A. The test period being used by the Company is the twelve-month period ending December 31, 2011, presented on a pro forma basis.

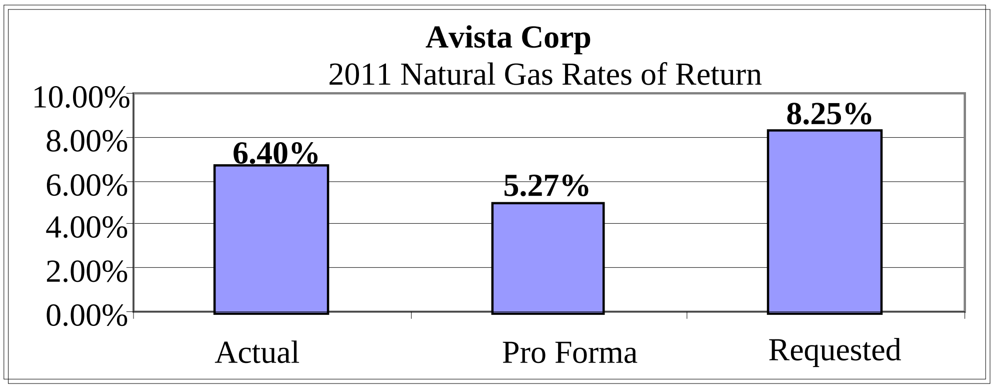
Q. When was the last change to base rates in the Washington jurisdiction?

A. The last change to base natural gas rates in Washington occurred on January 1, 2012 as a result of the Order received in Docket No. UG-110877.

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

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

Illustration No. 3



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

A. The Company's natural gas request is driven mainly by increases in Net Plant Investment and by changes in various operating cost components, such as distribution O&M and A&G expenditures[13]. The total of the increased operating cost components requested in

[13] Increased plant investment and expenses discussed in this section of my testimony represent an approximate breakdown of amounts between the Company's request in this case compared to that approved in the Company's prior general rate case proceeding in Docket Nos. UE-100467 and UG-100468. Due to the black-box nature of the Company's prior settlement approved by the WUTC in Docket No. UE-110876 and UG-110877, the Company made certain assumptions as to the amounts approved for various rate base and expense items for use in the discussion that follows.

this case causes an increase in the fixed costs of providing gas service to customers.

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

A. Looking at the changes to "gross" plant in service, Washington "gross" plant increased by approximately $44.6 million, as compared to what is currently included in rates. Distribution "gross" plant increased approximately $27 million above the current level included in rates, while general "gross" plant increased $17.1 million. After adjusting for accumulated depreciation and amortization, and accumulated deferred income taxes, the net increase to rate base from these items is $12.3 million. The Company also included a decrease in the rate base value of gas inventory, as result of reduced gas prices, of $3.1 million from that included in the previous general rate case. Lastly the Company included a slight deduction related to miscellaneous regulatory items of $1.0 million. In addition to discussing the actual restating and pro forma adjustments made to the test period regarding net plant investment, Mr. DeFelice also describes the 2012 and 2013 general plant and gas distribution plant investments, as well as the 2011 plant additions annualized for purposes of the Company's case.

Q. What were the major components of the Distribution, O&M and A&G Expense?

A. A number of expense items have increased since the 2010 test year pro forma used in the last rate case. For example, employee benefits such as wages, pension and medical insurance expenses have increased. We are utilizing a 2011 test year; however, new general natural gas rates resulting from this filing are not expected to go into effect until the first half of 2013. Accordingly, the Company has included a number of pro forma adjustments to capture some of the cost changes that the Company will experience from the test year. In particular, the Company has pro formed in the increased costs associated with employee salaries, pension and medical expenses of approximately $1.5 million. Ms. Feltes discusses the cause of the increased pension and medical expenses in her testimony, along with the overall compensation levels of all Company employees.

<u>Revenue Requirement</u>

Q. Would you please explain what is shown on page 1 of Exhibit No._____(EMA-3)?

A. Yes. Exhibit No._____(EMA-3), page 1, shows actual and pro forma natural gas operating results and rate base for the test period for the State of Washington. Column (b) of page 1 of Exhibit No._____(EMA-3) shows 2011 operating results (twelve-months ended December 31, 2011) and components of the average-of-monthly-average rate base as recorded; column (c) is the total of all adjustments to net operating income and rate base; and column (d) is pro forma and attrition adjusted results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company to earn an 8.25% rate of return. Column (f) reflects total pro forma and attrition adjusted natural gas operating results with the requested increase of $10,088,000.

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

A. Yes. Page 2 shows the calculation of the $10,088,000 revenue requirement at the requested 8.25% rate of return.

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

A. Page 3 shows the proposed Cost of Capital and Capital Structure utilized by the Company in this case, and the weighted average cost of capital calculation of 8.25%. Mr. Thies discusses the Company's proposed rate of return and the pro forma capital structure utilized in this case, while Dr. Avera provides additional testimony related to the appropriate return on equity for Avista.

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

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

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

A. Yes. Page 5 begins with actual operating results and rate base for the test period in column (1.00). Individual normalizing adjustments that are standard components of our annual reporting to the Commission begin in column (1.01) on page 5 and continue through column (2.13) on page 7.[14] Individual pro forma adjustments are shown on page 8 in columns (3.00) though (3.06). The first two columns shown on page 9 columns (4.00) and (4.01) on page 9 relate to the "attrition" effect of the 2012 and 2013 capital additions that will be in place during the period that new retail rates will be in effect (essentially the 2013 calendar year). The final columns, shown on page 9 of Exhibit No._____(EMA-3),

[14] The restated total also includes an increase in expense related to the 6-year average of incentives.

(4.02) and (4.03) are final pro forma adjustments necessary for known offsets, with the final column on page 9 (column F-Ttl) representing the proposed "Final Total" operating results and rate base for the test period.

The Company has also provided workpapers, both in hard copy and electronic formats, outlining additional details related to each of the adjustments or components noted above.

__**Standard Commission Basis and Restating Adjustments**__

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

A. Yes, but before I begin, as explained in the electric section above, the Company made a few changes to the **Results of Operations** column (1.00), reflecting the Company's actual natural gas operating results and rate base.

In past general natural gas rate case filings based on past Commission orders, this column represented actual net operating income and __net utility plant__, which included balances after accumulated depreciation and amortization, but before accumulated deferred income taxes (DFIT) and other rate base adjustments impacting the Company's actual net rate base results. Accumulated DFIT and other rate base adjustments were included as "Standard Commission Basis and Restating Adjustments" to be consistent with prior Commission orders, resulting in a "Restated Total" provided within the Company's filing.

In this filing however, column (1.00) Results of Operations reflects the actual operating results and total net rate base experienced by the Company for 2011 on an average-of-monthly-average (AMA) basis, including Accumulated DFIT and other rate base adjustments previously shown as restating adjustments. Columns following the Results of Operations column (1.00) reflect restating adjustments necessary to: restate the actual results based on prior Commission orders; reflect appropriate annualized expenses; correct for errors; or remove prior period amounts reflected in the actual 2011 results.

Q. Please continue with your explanation of each adjustment and its effect on test period net operating income and/or rate base?

A. The first adjustment, column (1.01) on page 5, entitled **Deferred FIT Rate Base**, adjusts the DFIT rate base balance included in the Results of Operations column (1.00) to the corrected DFIT balance, as shown within my workpapers provided with the Company's filing. Accumulated DFIT reflects the deferred tax balances arising from accelerated tax depreciation (Accelerated Cost Recovery System, or ACRS, and Modified Accelerated Cost Recovery, or MACRS) and bond refinancing premiums. These amounts are reflected on the average-of-monthly-average balance basis. The effect on Washington rate base for this correction is a reduction of $297,000. A decrease to Washington net operating income of $3,000 is due to the Federal income tax (FIT) expense on the restated level of interest on the change in rate base[15].

The adjustment in column (1.02), **Deferred Debits and Credits,** is a consolidation of previous commission basis or restating other rate base adjustments and their net operating income (NOI) impact as described in the electric section above. The net impact on a consolidated basis of this adjustment increases Washington rate base by $12,000. Washington net operating income (NOI) decreases by a total of $29,000.

As noted above, the 2011 AMA actual rate base amounts of other rate base adjustments are included in the Results of Operations column (1.00). Adjustments included in the Deferred Debits and Credits consolidated adjustment are those necessary to reflect restatements from actual results based on prior Commission orders, and are explained below. For consistency with prior rate case filings, a description of each previously separated adjustment is included below.

The following items are included in the consolidation:

- **<u>Gain on Office Building</u>** reflects the removal of the amortization expense and AMA rate base balance included in the Company's 2011 test period related to Washington's portion of the amortized gain on the sale of the Company's general office facility. The facility was sold in December 1986 and leased back by the Company. Although the Company repurchased the building in November 2005, the Company opted to continue to amortize the deferred gain over the remaining amortization period ending in 2011. The average of monthly averages (AMA) amount of the deferred gain for the 2013 rate period is zero. The use of AMA for the rate period was ordered in Order No. 01 in Docket No. U-071805. The effect on

[15] An additional change the Company has made from prior filings, is that the net effect of Federal income tax (FIT) expense on the restated level of interest expense due to a change in rate base, is shown within <u>each</u> individual adjustment rather than as a consolidated adjustment previously included in the Company's "Restate Debt Interest" adjustment. The restated debt interest impact per individual adjustment can be seen on Line 28 of Exhibit No. EMA __(EMA-3). As discussed later in my testimony, the "Restate Debt Interest" adjustment restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies, on the Results of Operations level of rate base shown in column (1.00) only, resulting in a revised level of tax deductible interest expense on actual test period rate base.

Washington rate base is an increase of approximately $14,000. The effect on Washington operating income is a decrease of approximately $28,000.

- **Customer Advances** decreases rate base for money advanced by customers for line extensions, as they will be recorded as contributions in aid of construction at some future time. The reduction to rate base per results of operations is $20,000. The correct amount is $22,000. A reduction to Washington rate base of $2,000 is necessary to properly reflect the removal of customer advances.
- **Customer Deposits** reduces natural gas rate base by the average-of-monthly-averages of customer deposits held by the Company, as ordered by this Commission in Docket UE-090135. The reduction to rate base per results of operations is accurately reflected at approximately $990,000; therefore no adjustment is necessary to rate base. The corresponding interest paid on customer deposits is reclassified to utility operating expense, at the current UTC interest rate of 0.26%. The effect on Washington operating income is a decrease of $1,000.

Q. Please continue describing the remaining adjustments on page 5.

A. The adjustment in column (1.03), **Gas Inventory & JP Storage Restating**, reflects the adjustment to rate base for the value of natural gas stored at the Company's Jackson Prairie underground storage facility on a 2013 AMA basis. This adjustment is necessary to reflect the increased level of inventory transferred to the Utility on May 1, 2011.[16] Due to the need for this annualized calculation, the Company has included the updated lower natural gas prices expected during the 2013 rate period. In addition, underground storage expense increased for the additional operating expense the Company is now incurring by approximately $200,000. The impact of this adjustment decreases Washington net operating income by $123,000 and increases rate base by $649,000.

The adjustment in column (2.01), entitled **Revenue Normalization & Gas Cost Adjustment**, is an adjustment taking into account known and measurable changes that include revenue normalization (including the current authorized rates approved in Docket

[16] Company witness Mr. Christie discusses the Jackson Prairie Storage Facility within his testimony.

No. UG-110877), which reprices customer usage under presently effective rates, as well as weather normalization and an unbilled revenue calculation. Associated natural gas costs are replaced with natural gas costs computed using normalized volumes at the currently effective "weighted average cost of gas," or WACOG rates. Revenues associated with the temporary Gas Rate Adjustment Schedule 155 and Schedule 191 Tariff Rider are excluded from pro forma revenues, and the related amortization expense is eliminated as well. Ms. Knox is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $1,541,000.

The adjustment in column (2.02), **Eliminate B & O Taxes**, eliminates the revenues and expenses associated with local business and occupation taxes, which the Company passes through to customers. The adjustment eliminates any timing mismatch that exists between the revenues and expenses by eliminating the revenues and expenses in their entirety. B & O Taxes are passed through on a separate schedule, which is not part of this proceeding. The effect of this adjustment is to decrease Washington net operating income by $5,000.

Q. Please turn to page 6 and explain the first column shown there, and the adjustments that follow.

A. The first adjustment on page 6 in column (2.03), **Uncollectible Expense**, restates the accrued expense to the actual level of net write-offs for the test period. The effect of this adjustment is to increase Washington net operating income by $237,000.

The adjustment in column (2.04), entitled **Regulatory Expense Adjustment**, restates recorded 2011 regulatory expense to reflect the UTC assessment rates applied to revenues for the test period. The effect of this adjustment is to decrease Washington net operating income by $29,000.

The adjustment in column (2.05), entitled **Injuries and Damages**, is a restating adjustment that replaces the accrual with actuals to obtain the six-year rolling average of injuries and damages payments not covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T, the Company changed to the reserve method of accounting for injuries and damages not covered by insurance. The effect of this adjustment is to decrease Washington net operating income by $121,000.

The adjustment in column (2.06), entitled **FIT/DFIT Expense**, adjusts the FIT calculated at 35% within Results of Operations by removing the effect of certain Schedule M items and matches the jurisdictional allocation of other Schedule M items to related Results of Operations allocations. This adjustment also reflects the proper level of deferred tax expense for the test period. The effect of this adjustment, all based upon a Federal tax rate of 35%, is to increase Washington net operating income by $10,000.

The adjustment in column (2.07), **Net Gains/Losses**, reflects a ten-year amortization of net gains realized from the sale of real property disposed of between 2002 and 2011. This restating adjustment is made as a result of the Commission's Order in Docket No. UG-050483 and consistent with previous Company general rate cases. The effect of this adjustment is to increase Washington net operating income by $2,000.

The adjustment in column (2.08), **Eliminate A/R Expenses**, removes expenses incurred associated with the fees charged the Company for its customer accounts receivable program. The Company’s accounts receivable program was terminated in December 2010.

The effect of this adjustment was diminimus and rounds to $0. This adjustment will be removed from future rate case proceedings.

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

A. The first adjustment on page 7 in column (2.09), **Office Space Charges to Subs**, removes a portion of the office space costs (building lease and O&M costs, common area costs, copier expense and annual office furniture rental) using the relationship of labor hours charged to subsidiary activities by employee compared to total labor hours by employee. These percentages are applied to the employees' office space (expressed in square feet) and multiplied by office space costs/per square foot. This restating adjustment is made as a result of the Commission's Third Supplemental Order in Docket No. U-88-2380-T and consistent with previous Company general rate cases. The effect of this adjustment is to increase Washington net operating income by $1,000.

The adjustment in column (2.10), **Restate Excise Taxes**, removes the effect of a one-month lag between collection and payment of taxes. The effect of this adjustment is to decrease Washington net operating income by $1,000.

The adjustment in column (2.11), **Miscellaneous Restating Adjustments**, removes a number of non-operating or non-utility expenses associated with advertising, dues and donations, etc., included in error in the test period actual results, and removes or restates other expenses incorrectly charged between service and or jurisdiction totaling approximately $7,000. I describe further the process for removing or restating certain expenses from the Company's test period in Section VI (Compliance with Commission Order No. 6, Docket Nos. UE-110876 & UG-110877) discussed below.[17]

The Company also removed 50% of director meeting expenses, as ordered in Docket No. UE-090135, and 10% of director fees totaling approximately $18,000. The total effect of this adjustment is to increase Washington net operating income by $16,000.

The adjustment in column (2.12), **Restating Incentives,** restates the actual incentives included in the Company's test period using a six-year average adjusted by the Consumer Price Index**.** I discuss further in Section V (Appropriateness & Normalization of Incentive Costs) the basis for the use of a six-year average. The effect of this adjustment is to decrease Washington net operating income by $132,000.

The adjustment in column (2.13), **Restate Debt Interest**, restates debt interest using the Company's pro forma weighted average cost of debt, as outlined in the testimony and exhibits of Mr. Thies, on the Results of Operations level of rate base shown in column (1.00) only, resulting in a revised level of tax deductible interest expense on actual test period rate base. The Federal income tax effect of the restated level of interest for the test period increases Washington net operating income by $22,000.

The Federal income tax effect of the restated level of interest on all other rate base adjustments included in the Company's filing are included and shown in each individual rate base adjustment described elsewhere in this testimony.

[17] As discussed later in my testimony, additional changes in A&G expense due to errors discovered during the process of the Company's internal audit of accounting practices and subsequent review by Rates Department personnel for similar transactions, would have the effect of reducing electric A&G expense by approximately $3,300.00 and increasing natural gas A&G expense by approximately $2,500.00. The corrections to electric and natural gas expense were found after the completion of the Company's revenue requirement filed in this case and should be adjusted in the final revenue requirement approved in this proceeding.

The last column on page 8, entitled **Restated Total**, subtotals all the preceding columns (1.00) through column (2.13). These totals represent actual operating results and rate base plus the standard normalizing adjustments that the Company includes in its annual Commission Basis reports.[18]

Pro Forma Adjustments

Q. Please explain the significance of the 7 columns starting on page 8 of your Exhibit No._____(EMA-3).

A. The adjustments starting on page 8 are pro forma adjustments to reflect known and measurable changes between the test period and the pro forma period. In this case, they encompass revenue and expense items, and natural gas capital projects. These adjustments bring the operating results and rate base to the final pro forma sub-total level for the test year prior to the attrition adjusted total included in the Company's filing.

Q. Please provide an explanation of these adjustments shown on page 8.

A. The adjustment in column (3.00), **Pro Forma Labor-Non-Exec**, reflects known and measurable changes to test period union and non-union wages and salaries, excluding executive salaries, which are handled separately in adjustment 3.01. For non-union employees, test period wages and salaries are restated to include the March 2012 overall actual increase of 3.0%, and 10 months of the planned March 2013 increase of 2.5%. Ms. Feltes discusses the Company's overall compensation plan and notes that the 2.5%

[18] The restated total also includes an increase to annualize the JP Storage facility inventory rate base balance and operating expenses, as well as an increase in expense for a 6-year average of incentives.

minimum increase will be presented to the Compensation Committee of the Board of Directors for approval at the Board's May 2012 meeting.

Also included in this adjustment are the 2012 and 2013 union contract increases agreed to in 2010 of 3.0% for both years. The methodology behind this adjustment is consistent with that used in the Company's previous Docket No. UE-110877. The effect of this adjustment on Washington net operating income is a decrease of $382,000.

The adjustment in column (3.01), **Pro Forma Labor-Executive**, reflects known and measurable changes to allocated executive officer salaries, (as explained in the Electric Section above) and increases Washington net operating income is a slight increase of $8,000. It otherwise contains no increase in executive officer base pay.

The adjustment in column (3.02), **Pro Forma Employee Benefits**, adjusts for changes in both the Company's pension and medical insurance expense (as explained in the Electric Section above) and decreases Washington net operating income by $597,000.

The adjustment in Column (3.03), **Pro Forma Insurance**, adjusts the test period insurance expense for general liability, directors and officers ("D&O") liability, and property to the actual cost of insurance policies that are in effect for 2012 (as explained in the Electric Section above). This adjustment increases Washington net operating income by $18,000.

The adjustment in column (3.04), Pro Forma **Property Tax**, (as explained in the Electric Section above), restates the 2011 test period accrued level of property taxes expense to the 2013 rate period level. As can be seen from my workpapers provided with the Company's filing, the property on which the tax is calculated is the property value as of December 31, 2012, reflecting the 2013 level of expense the Company will experience during the rate period. The effect of this particular adjustment is to decrease Washington net operating income by $182,000.

The adjustment in Column (3.05), **Pro Forma Atmospheric Testing**, adjusts the test period expense for Atmospheric Corrosion expense. This is an inspection program to find conditions in the Company's system that could lead to corrosion issues on customer meter sets. This program is a federally-mandated program that requires the Company to inspect all above ground steel pipe at a frequency not to exceed three-years. This expense is on a three-year rotation between the Company's jurisdictions (Washington, Idaho, and Oregon) and is therefore, coded directly to Washington operations for the year in which the inspection occurs (2012 for Washington estimated at a total cost of $525,000). To be consistent in all three of Avista's natural gas jurisdictions, the Company had included a three-year amortization from 2011-2013 of expense of $150,000 in its previous Washington rate proceeding. The actual 2012 level of expense is expected to be higher than previously projected. Based on the $150,000 previously included, the amortization needed for the remaining two years to equate to the $525,000, is $187,500 for atmospheric O&M expense. The Company has received approval of this accounting treatment in its Oregon jurisdiction. Due to the black-box nature of the settlements approved in both Avista's Washington and Idaho jurisdictions in the previous rate cases, the Company will be requesting this treatment again in the Company's next Idaho general rate case as well, so the Company remains whole on an annual basis. This adjustment was made under the direction of Company witness Mr. Kopczynski and is described further in his testimony. This adjustment decreases Washington net operating income by $122,000.

The adjustment in column (3.06), **Restating 2011 Capital,** restates plant additions included in the test year on an AMA basis to an end of period basis, together with the associated accumulated depreciation and deferred federal income taxes at a 2011 end of period basis, as described further by Mr. DeFelice. This adjustment also includes the annual level of associated depreciation expense on all plant-in-service at December 31, 2011.

The effect of this adjustment on Washington net operating income is a decrease of $156,000. The effect on Washington total rate base is an increase of $7,165,000.

The last column on page 8, **Pro Forma Sub-Total**, reflects total pro forma results of operations and rate base consisting of test period actual results (twelve-months ending December 31, 2011). (This sub-total is prior to the attrition and restating pro forma adjustments described below, producing the Final Total results utilized in the Company's final revenue requirement requested in this case.)

Q. At this point, what does the Pro Forma total column show is the revenue requirement need for Avista?

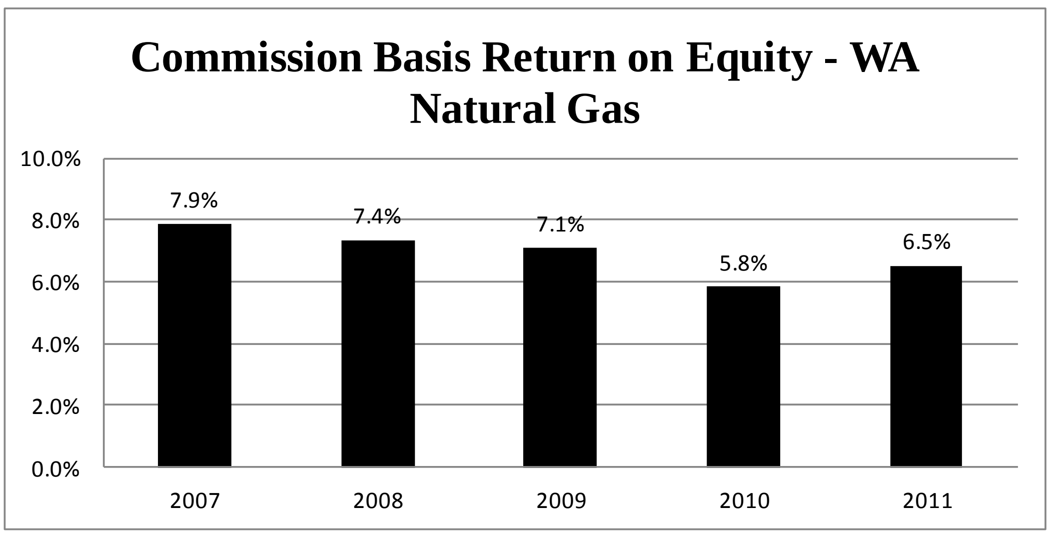
A. As can be seen on Line 49, Column Pro Forma Sub-Total, Page 8 of Exhibit No. __(EMA-3), the revenue requirement at this point, including restating and pro forma rate case adjustments to the historical test period, shows a revenue shortfall or revenue requirement need of $6.9 million.

<u>Impact of 2012 and 2013 Capital Additions</u>

Q. Is the Company experiencing the same erosion in earnings in its natural gas distribution business, as was the case with its electric operations?

A. Yes. The Company will experience the same erosion in earnings ("attrition") in its natural gas distribution business, resulting from planned capital additions in 2012 and 2013, as has been true in the past. The bar chart in Illustration No. 4 below shows Avista's actual earned return on equity (ROE) each year from 2007 to 2011 for our natural gas operations in the State of Washington. The ROEs range from 5.8% to 7.9%, and are all well below ROEs approved by the Commission in recent years for utilities in Washington, whether through settlement or litigation.

Illustration No. 4

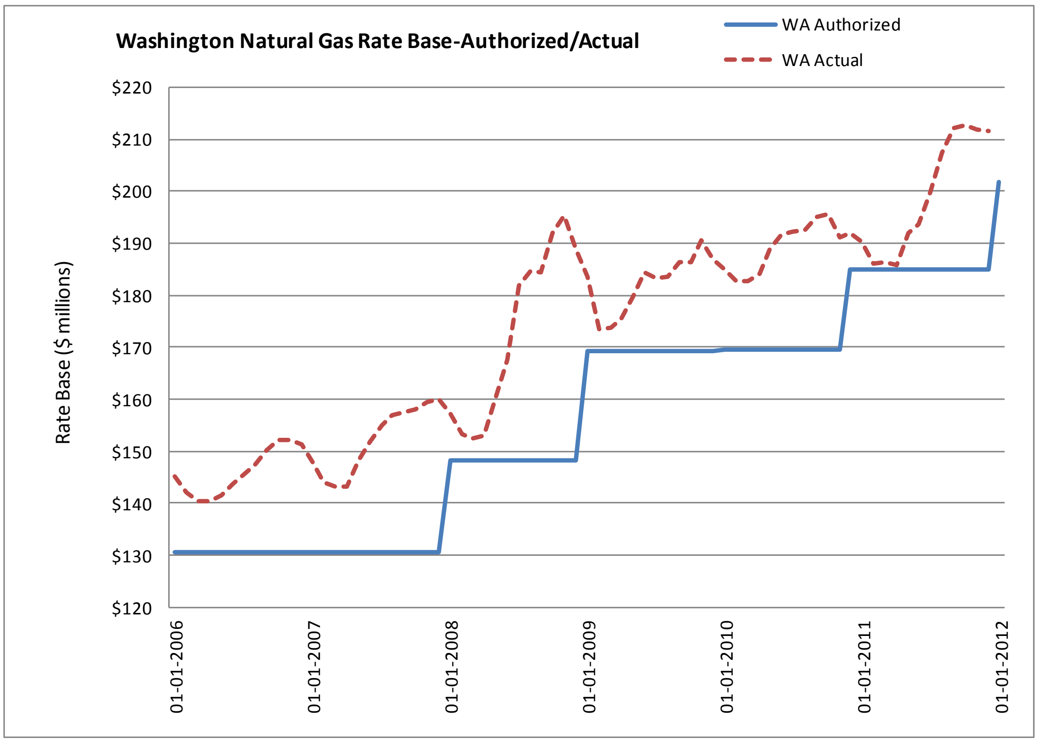


During this five year period, the Company's natural gas rate base grew by $60 million, or approximately 40%, while therm sales grew by only 2.2%. (See also Illustration No. 3 in Mr. Morris Exhibit No. __(SLM-1T) p. 10, showing the difference between actual and projected retail therm and kWh sales and net plant investment.)

Q. Have you prepared an illustration of the difference, over time, of the actual rate base versus the rate base authorized to be included in rates?

A. Yes. Illustration No. 5, below, shows the "stair-step" nature of the rate base authorized to be included in rates. As you can see, this clearly lags behind the actual level of natural gas rate base dedicated to serving our customers.

<u>Illustration No. 5</u>



Q. Did the Company attempt to determine the impact of the erosion in earnings resulting from planned capital additions in 2012 and 2013?

A. Yes. I used the same approach on the gas side that I used for purposes of "cross-checking" the electric attrition adjustment, and believe my calculations would appropriately capture the earnings attrition related to 2012-2013.

Q. What did your analysis show?

A. The impact on revenue requirement of 2012 and 2013 natural gas capital additions is $2.676 million. (See Exhibit No. __(EMA-3), p. 9, column (4.01), line 48.) Stated differently, if 2012 and 2013 capital additions are not included in rate base, the Company will experience $2.676 million in earnings erosion, or "attrition." This revenue shortfall translates into approximately a 1.6% reduction in return on equity (.79% reduction in rate of return) with respect to its natural gas business.

Illustration No. 6 below captures these calculations:

Illustration No. 6

AVISTA UTILITIES
Impact of Attrition on Rate of Return and Return on Equity
and Revenue Requirement
State of Washington - Natural Gas

Line No.	Description		(000's of Dollars)
1	Rate base with 2012/2013 capital additions		$210,004
2	Rate base before 2012/2013 capital additions		204,108
3	Increase in rate base due to 2012/2013 capital additions		$5,896
4	Proposed rate of return		8.25%
5	Net operating income (NOI) requirement - return on rate base (line 3 * 4)		$486
6	NOI deficiency related to:	2012 capital additions	905
7		2013 AMA capital additions	270
9	Total NOI deficiency related to 2012/2013 capital additions		$1,661
10	Reduction in rate of return due to 2012/2013 capital additions (line 9 / line 1)		0.79%
11	Common equity portion of capital structure		48.40%
12	Reduction in return on equity due to 2012/2013 capital additions (line 10 / line 11)		1.63%
13	Total NOI deficiency related to 2012/2013 capital additions from line 9		$1,661
14	Conversion factor		0.62095
15	Revenue requirement due to 2012/2013 capital additions		**$2,676**

Q. Please explain the significance of the first 3 columns shown on page 9 of your Exhibit No.____(EMA-3).

A. The first two columns (**Capital Add 2012** and **Capital Add 2013**) on page 9 relate to the 2012 and 2013 capital additions that will be in place during the period that new retail rates will be in effect (essentially the 2013 calendar year), and total $5.896 million. The associated revenue requirement is $2.676 million, as shown in column (4.01), line 48.

These two components are described briefly below, and additional details are provided by other Company witnesses, as indicated.

The third column shown on page 9, labeled Attrition Adjusted Revenue Requirement, represents the Company's results of operations and rate base, after measuring the earnings erosion after taking into account the planned capital additions in 2012 and 2013, resulting in a total adjusted revenue requirement of $9.576 million, reflecting all previous pro forma adjustments, as well as my attrition calculation.

Q. Please further explain the 2012 and 2013 capital addition components included on page 9 of Exhibit No. __(EMA-3).

A. The first component included in column (4.00), **Capital Additions 2012**, reflect all 2012 capital additions (excluding distribution related capital expenditures made that are associated with connecting new customers to the Company's system) together with the associated accumulated depreciation and deferred federal income taxes at a 2012 EOP basis. This component also includes associated depreciation expense for the additions. In addition, the plant-in-service at December 31, 2011 is reflected on a 2012 EOP basis. Mr. DeFelice describes this component in detail within his testimony. This decreases Washington net operating income by $905,000 and increases total rate base by $5,255,000.

The second component included in column (4.01), **Capital Additions 2013**, reflects all 2013 capital additions (excluding distribution related capital expenditures made that are associated with connecting new customers to the Company's system) together with the associated accumulated depreciation and deferred federal income taxes at a 2013 AMA basis. This component also includes associated depreciation expense for the additions. In addition, the plant-in-service at December 31, 2012 is reflected on a 2013 AMA basis. Mr. DeFelice also describes this component in detail within his testimony. This decreases Washington net operating income by $270,000 and increases total rate base by $641,000.

As noted above, the third column shown on page 9, labeled <u>Attrition Adjusted Revenue Requirement</u>, shows the revenue requirement of $9.576 million after taking into account my other previous pro forma adjustments as well as the planned capital additions in 2012 and 2013.

<u>Remaining Pro Forma Adjustments</u>

Q. Starting in the fourth column on the last page of Exhibit No. __(EMA-3), page 9, there are two final adjustments and a total column, could you please explain the purpose of these adjustments.

A. Yes. The final two adjustments included on page 9, are adjustments that are necessary to restate the <u>Adjusted Revenue Requirement</u> (column ADJ-Ttl) on page 9, to reflect the **Final Total** producing the revenue requirement requested in this case of $10.088 million. These two adjustments were necessary to include after because they reflect further adjustments for known offsets.

Q. Please describe the individual adjustments shown on page 9?

A. Yes. The first adjustment in column (4.02), **Depreciation Study,** as discussed by Mr. DeFelice, reflects the Company's proposed changes in depreciation rates pertaining to <u>natural gas</u> plant-in-service using the recently-completed depreciation study performed by Gannett Fleming, Inc. Additional workpapers, including the detailed Depreciation Study prepared by Gannett Fleming, Inc., are included with Mr. DeFelice's workpapers provided with the Company's filing. The effect of this adjustment on Washington net operating income is a decrease of $326,000.

The final adjustment column is (4.03), **O&M Offsets**. As explained by Mr. DeFelice, all of the 2012 and 2013 capital additions were reviewed for any O&M offsets that were expected in the 2013 rate period. Any specific offset that was identified, was included in the pro forma adjustment as a reduction to O&M costs and discussed in Mr. DeFelice's direct testimony along with the capital asset for which the offset relates. The effect of this adjustment on Washington net operating income is an increase of $8,000.

<u>Revenue Requirement Summary</u>

Q. Referring back to page 1, line 48, of Exhibit No._____(EMA-3), what was the actual and pro forma natural gas rate of return realized by the Company during the test period?

A. For the State of Washington, the actual test period rate of return was 6.4%. The pro forma rate of return is 5.27% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the 8.25% rate of return requested by the Company in this case.

Q. How much additional net operating income would be required for the State of Washington natural gas operations to allow the Company an opportunity to earn its proposed 8.25% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $6,264,000, as shown on line 5, page 2 of Exhibit No._____(EMA-3). The resulting revenue requirement is shown on line 7 and amounts to $10,088,000 or an increase of 7.00% over pro forma general business and transportation revenues.

V. APPROPRIATENESS & NORMALIZATION OF INCENTIVE COSTS

Q. What did the Company include for employee incentives in this case?

A. For this filing, Avista has adjusted the actual level of incentive expense for the 2011 test period to reflect a six-year average, adjusted for CPI. For Washington electric service, the test period expense of $1.663 million was increased approximately $631,000 for the six-year average and approximately $118,000 for the CPI increase, resulting in a total increase of $749,000. For Washington natural gas service, the test period expense of $451,000 was increased approximately $171,000 for the six-year average and approximately $32,000 for the CPI increase, resulting in a total increase of $203,000.

Q. Please explain why the Company has increased its cost above the test year level.

A. Over the past eight years, since the 2005 general rate case (GRC) (utilizing a 2003 test period), the Company has been allowed to recover the test period level included in the case with the exception of the 2007 and 2011 GRCs discussed below[19]. As part of a settlement in the 2007 GRC (Docket Nos. UE-070804 and UG-070805) the Commission

[19] See Docket Nos. UG-041515, UE-050482; UG-050483; UE-080416; UG-080417; UE-090134; UG-090135; UE-100467 and UG-1004968.

approved a level of incentive amount based on an average of several years, as proposed by Staff. In the 2011 GRC, a black-box settlement was approved, and although the parties did not specifically identify the level of incentives included in the case, the Company's direct filed case included a decrease to the Company's requested revenue requirement due to the use of a six-year average utilized.

However, although the inclusion of the current incentive plan expenses has not been opposed for inclusion in the Company's rates collected from customers over the past several cases, there has been disagreement between the parties over the use of, or calculation of, an average or normalization of incentive expenses since the 2007 electric and gas GRCs. In addition, in Docket No. 090134, paragraph 129, the Commission requested that "... if the cost of incentives is appropriate to include in rates, parties should also explain whether these costs should be normalized."

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

A. In the Company's 2007 general rate case settlement agreed to by the parties and ultimately approved by this Commission (Docket Nos. UE-070804 and UG-070805), a form of average (or levelizing) as proposed by Staff was utilized which resulted in a decrease to the Company's originally requested revenue requirement. Staff witness Mr. Kermode, at page 23, lines 5-14, of his testimony (Exhibit No. 69 (DPK-1T) in that docket stated as follows:

> The Incentive payout from 1999 to 2006 varied from $0 to $5,864,642, according to the Company's response to Staff Data Request #232 - Supplemental. Avista did not pay any incentive payout during two out of the past eight years. It is my opinion that the test year's higher than normal

> incentive compensation should not be included in the company's results of operations used to determine rates but, rather, a levelized expense should be used instead. ….. I levelized the high and low incentive payouts by averaging the past eight years of incentive payouts.

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

A. Yes. Since annual Company incentive plan payouts can often vary year-to-year, the Company continues to believe an average of annual payouts is most appropriate in order to "normalize" these costs. Often where there are revenues or expenses that can vary significantly from year-to-year, the Commission has approved averages to properly reflect a fair and reasonable level of revenue or expense to be included in customers' rates. Utilizing a six-year average of the Company's incentive plan payouts is consistent with other averaging methods utilized by this Commission in past proceedings.

Illustration No. 7 below shows the incentives that have been paid since 2006 (Line No. 3) and the amount that has been allocated to Washington electric ratepayers (Line No. 4). It also shows the normalizing adjustments that were agreed to in the 2007 and 2011 GRCs (Line No. 5) and the proposed adjustment in the current filing. As can be seen from the table, Line 4, there is large variability that can occur in each year in payout, and therefore variability in customer rates will result if an average was not utilized.

Illustration No. 7

Historical Incentive Plan Payout

Line No.							
1	Test Period	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
2	Rate Case	**(UE-070804)**	**(UE-080416)**	**(UE-090134)**	**(UE-100467)**	**(UE-110876)**	**Current Filing**
3	System Expense	$ 4.406	$ 3.255	$ 2.856	$ 5.059	$ 9.371	$ 3.428
4	WA - Electric Share	$ 2.141	$ 1.582	$ 1.388	$ 2.459	$ 4.491	$ 1.663
5	Normalization Adjustment	(1.006)	-	-	-	(2.052)	0.631
6	Recovered in Rates/Proposed	$ 1.135	$ 1.582	$ 1.388	$ 2.459	$ 2.439	$ 2.294

Note:
CPI Index was removed from analysis.

The illustration above reflects the restating (reduction) / increase to test period expense of ($2.052) million and $0.631million (Washington electric) for the years 2010 and 2011 respectively (Line No. 5). Therefore, customers benefited from the $2.052 million reduction to the Company's revenue requirement in the previous GRC. To exclude this six-year average in the current case, would understate the expense that the Company has incurred over time, preventing the Company from recovering its costs over time, although customers have benefited from the O&M savings that have occurred, and triggered the incentive payout.

Q. Please describe briefly the Company's current incentive plan and the appropriateness of including incentives in retail rates.

A. Company witness Ms. Feltes' direct testimony, discusses at length the Company's employee incentive program, specifically identifying, explaining, and quantifying the program's benefits to ratepayers. (See Exhibit No.__(KSF-1T))

Ms. Feltes also explains how Avista's current incentive plan was first designed in 2002, the goal of which was to focus on three key elements: cost control, customer satisfaction and the reliability of the energy we provide to our customers.

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

Based on the information provided by Ms. Feltes, it is appropriate to include in rates the cost of the Company's incentive plan expenses because there is a benefit to our customers from a plan that specifically focuses on the three key elements discussed above: cost control, customer satisfaction and the reliability of the energy we provide to our customers.

Q. What are other examples where the use of a multi-year average has been approved by the Commission to determine the appropriate level of revenue or expense in a general rate case filing?

A. There are several examples of revenue or expense amounts which have been averaged or normalized and approved by this Commission. First, the Company has used a three-year average for OASIS wheeling and Dry Gulch transmission revenues, because these revenues vary year-to-year depending on electric energy market conditions. Avista has, in its previous rate case, used the most recent three-year averages as being representative of future expectations unless there are known events or factors that occurred during the period that would cause the average to not be representative of future expectations.

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

Yet another example discussed later in my testimony, relates to the four-year amortization, agreed to by the parties and approved by this Commission in Docket No. UE-110876, for the variability of thermal generating plant maintenance expense occurring at the Company's Coyote Springs 2 and Colstrip 3 and 4 plants.

Q. Briefly explain the reasoning behind the use of the CPI to adjust the average incentive level.

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

Q. Please summarize your request as it related to employee incentives?

A. The Company continues to believe that the use of an average would be the most appropriate method to determine incentives for ratemaking purposes. The Company proposes that the Commission approve the use of a six-year average for incentive expense, and include this adjustment in the ultimate outcome of this case.

VI. COMPLIANCE WITH COMMISSION ORDER NO. 6, DOCKET NOS. UE-110876 & UG-110877

Deferred Accounting Treatment for the Variability in Thermal Generating Plant Maintenance Costs

Q. Order No. 6, page 16, paragraph 37, in Docket No. UE-110876, approved on a "provisional basis," Avista's deferred accounting mechanism for its thermal maintenance costs associated with its Coyote Springs 2 and Colstrip 3 and 4 plants. Please explain how the deferred accounting mechanism on the thermal maintenance operates.

A. Per the Settlement Agreement approved in Order No. 6, Docket No. UE-10876, the Settling Parties agreed to a deferral of the variable maintenance costs associated with Avista's Coyote Springs 2 (CS2) natural gas-fired generating plant located near Boardman, Oregon, and the Company's fifteen percent ownership share of the Colstrip 3 and 4 coal-fired generating plants located in southeastern Montana.

In calculating the amount the Company defers in a given year, the Company compares actual, non-fuel, non-internal-labor maintenance expenses for the Coyote Springs 2 and Colstrip 3 & 4 plants, to the amount of the same expenses authorized for recovery in its last general rate case, and defers the difference from that currently authorized. The most recent authorized is established as the "baseline maintenance expense" used for the comparison. Actual maintenance expenses incurred in subsequent test years would be trued up to the baseline and any expenses over or under the "baseline" would be deferred.

The deferral occurs annually, with deferred costs being amortized over a four-year period, beginning in January of the year following the year the expenses were deferred.

Carrying charges are not applied to the unamortized balance. The comparison of actual to authorized (or baseline) costs would use the combined costs from the Coyote Springs 2 and Colstrip 3 & 4 plants. The reason for combining costs is to allow for the possibility that there might be lower than authorized costs from one plant that would offset higher than authorized costs from the other plant in a given year.

The Settlement approved in Order No. 6, established the Company's system "baseline" maintenance expenses at $9.123 million for 2009 and $6.419 million for 2010, based on actual maintenance expenses for those years. The 2009 baseline was used to determine the amount of deferral recorded in 2011, and the 2010 baseline will be used to determine the total 2012 deferral amount of thermal maintenance costs to be recorded. The 2011 combined CS2 and Colstrip 3 & 4 system baseline (based on actual maintenance expense for 2011) as proposed by the Company in this filing, is $8.327 million (Washington amount $5.433 million). As proposed, this "baseline" amount would be used in 2013 to determine the amount to defer (above or below) compared to actual thermal maintenance at the CS2 and Colstrip 3 and 4 plants during 2013.

Each of the "baselines" noted above were established by including non-fuel, non-internal-labor maintenance expenses included in Federal Energy Regulatory Commission (FERC) maintenance accounts 551-554 and Company organizational code C06 for CS2; as well as FERC maintenance accounts 510-514 and Company organizational code N06 for Colstrip 3 and 4.

Q. Would you please explain how the Company is accounting for the deferred maintenance expenses?

A. Pursuant to WAC 480-07-370(1)(b), when expenses exceed authorized (or "baseline"), the Company defers the Washington maintenance expenses referenced above by debiting Account 182.3 – Other Regulatory Assets, and crediting Account 407.4 - Regulatory Credits as the deferrals are recorded. Amortization is recorded by debiting Account 407.3 – Regulatory Debits, and crediting Account 182.3 – Other Regulatory Assets. No interest is accruing on the deferrals.[20]

Q. Please explain why the Company believes this thermal maintenance deferred accounting mechanism should continue.

A. Deferred accounting treatment for these two plants (specifically CS2 and Colstrip 3 and 4) is appropriate because both plants have highly variable maintenance schedules that are to be performed approximately every third or fourth year. This variability in maintenance schedules entails large cost swings for these plants in any given year. By deferring the variability in these maintenance expenses, and recovering them over a four-year period, these cost swings can be smoothed, or normalized, for both the Company (reducing annual impact to earnings) and for customers (smoothing a portion of the

[20] When the reverse happens and expenses are below authorized (or "baseline"), the Company defers the Washington maintenance expenses referenced above by using the same accounts. However, Account 182.3 – Other Regulatory Assets would be credited and Account 407.4 - Regulatory Credits would be debited as the deferrals are recorded. Amortization is recorded by crediting Account 407.3 – Regulatory Debits, and debiting Account 182.3 – Other Regulatory Assets. No interest accrues on the deferrals.

"lumpiness" of these expenses over time).

This fluctuation in maintenance costs is typically not experienced by the Company's other hydro electric facilities or its Kettle Falls wood-waste generating plant. However, each unit at Colstrip has a regularly scheduled overhaul every third year. Since we have two units, this means that two out of every three years we will have a scheduled maintenance outage with substantial associated costs. The maintenance interval at CS2 is based on hours of operation, which typically dictates an outage for major maintenance every forth year. These major outages are scheduled in accordance with Original Equipment Manufacturer (OEM) guidelines on wear patterns and cycles for key plant equipment.

Therefore, depending on <u>when</u> the maintenance outages for each of these plants occur, Avista can have as much as two scheduled outages in one year, or no scheduled outages, providing the potential for large cost fluctuations on a year-to-year basis. Unexpected outages also cause costs to fluctuate as more costs are incurred to repair the plant. However, in an unexpected outage situation, we may, on a case-by-case basis, have instances where maintenance expense may actually be lower than authorized, as a portion of the repair costs are likely to be capitalized. The use of deferred accounting would smooth out these costs as well.

Q. Did other Parties express support for the agreed-upon deferred maintenance mechanism approved in Docket No. UE-110876?

A. Yes. During the evidentiary hearing held on November 8, 2011, WUTC Chairman Goltz asked why this mechanism was in the public interest, and Mr. Schoenbeck, the witness representing the Industrial Customers of Northwest Utilities (ICNU), replied:

> I actually think, staying with just the test period values as adjusted is wrong. I actually do think you need to normalize the fact that the maintenance is occurring over four years, and smooth it over four years. So you basically have to either use some sort of a four-year average for the maintenance or come up with a benchmark, and then give a deferral balance either above or below that benchmark. So we're supportive of the maintenance deferral we came up with [in] this in case for several years. … So in my mind it was a win-win for the -- for the customers. And by levelizing the rates, normalizing the rates, it would be a more constant level as opposed to year-to-year fluctuations provided by the test period guidance,… (Schoenbeck, TR 169:5 – 170:2)

Staff witness Mr. Schooley also expressed support for the mechanism, when he observed:

> I think that smoothing of the expenses makes it, from test year to test year, less volatile in rates. So if you happen to get a high year and build that into rates, it helps the company in a sense. The next year it's lower so they can turn more profits as reported on the bottom line. But overall I think that standardizing this cost will perhaps make it easier from year to year to take out some of the volatility in rates, …….. (inaudible). (Schooley, TR., 173:25 – 174:7)

In addition, Mr. Schooley also offered the following comment:

> So I think it is not necessarily precedent-setting, but it is a step in the direction that many of the companies are looking down in terms of trying to smooth their expenses in order to mitigate the need for them to be requesting rates every year as well. I don't want to go down a line-item-by-line-item type of accounting for every variation in expenses, but we need to be broadening this concept in order to come up with fewer rate cases and sufficient returns to the utilities. (Schooley, TR., 175:14 – 175:22)

Lastly, it should be remembered that actual costs and "baseline" amounts used for the determination of the deferred maintenance expense are subject to review in future rate case proceedings, in order to establish whether the costs have been prudently incurred.

Q. What is the amount of actual non-fuel operations and maintenance costs for the Coyote Springs 2 and Colstrip 3 & 4 plants that were incurred in 2011?

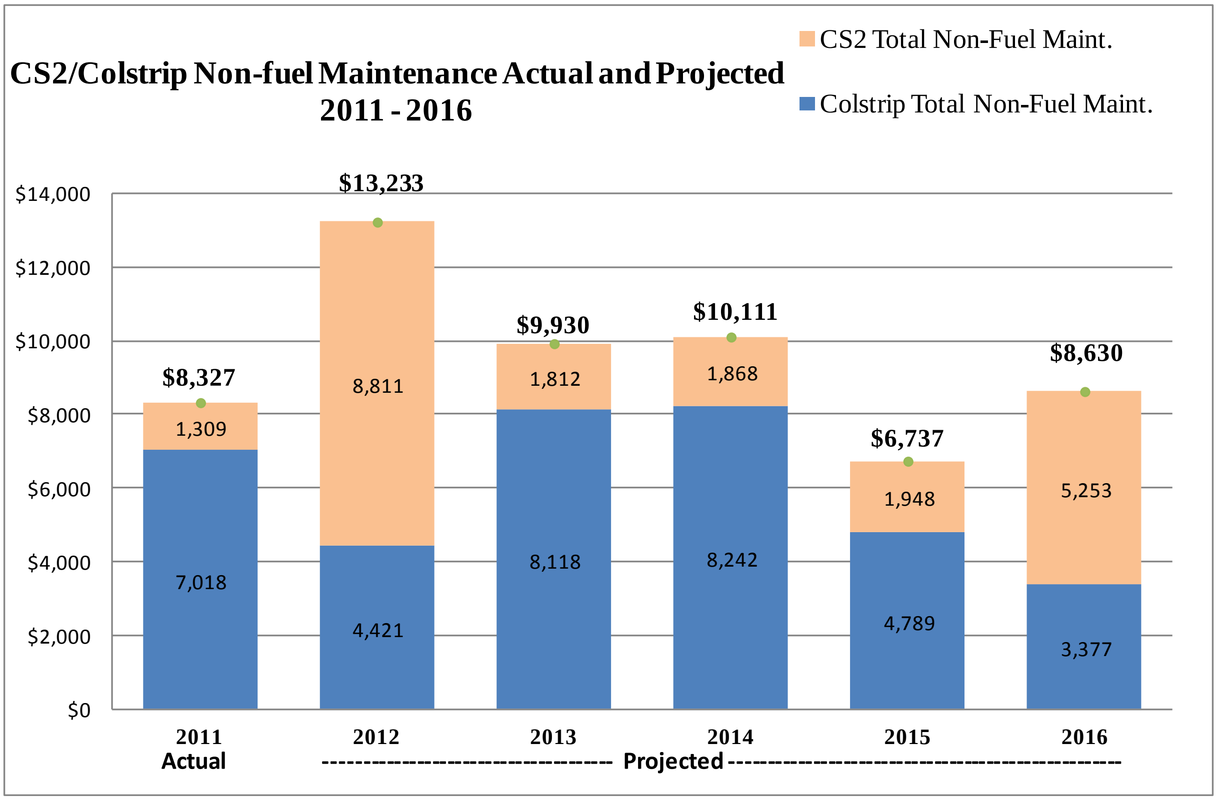
A. The amount of actual non-fuel maintenance costs incurred in 2011 for the indicated plants is shown below (millions):

Coyote Springs 2	$ 1.3
Colstrip 3 & 4	7.0
Total	$ 8.3

Q. What are future expectations for operation and maintenance costs for the Coyote Springs 2 and Colstrip 3 &4 plants?

A. The following Illustration No. 8 shows the forecast of non-fuel, non-internal-labor, maintenance costs for the plants separately, and in total, for the five-year period of 2012 through 2016, as well as the actual costs for the 2011 test period. The forecast shows major maintenance occurring for Coyote Springs 2 in 2012 and 2016, and for Colstrip 3 & 4 occurring in 2013 and 2014. Note that the total maintenance costs for both plants range from a high of $13.3 million in 2012 to a low of $6.7 million in 2015.

Illustration No. 8



Q. What amount of non-fuel maintenance expense for Coyote Springs 2 and Colstrip 3 & 4 should be included for recovery in the Company's general rate case?

A. The amount of expense included for recovery in this general rate case, is the actual maintenance expense recorded in the 2011 test period, less the amount deferred during the 2011 test period, plus the amortization of the previously deferred costs expected in 2013.

Q. Has the Company included any deferred maintenance amortization expense in this case for 2013 above that included in the 2011 test period?

A. Yes. The Company has included approximately $981,000 of deferred maintenance amortization expense expected in 2013, which equates to 1/4 of the deferred maintenance expense recorded in 2011 and 2012, to be amortized over four years.

Q. Why is the Company using a four-year amortization period?

A. A four-year amortization period was agreed to by the parties in the Company's last rate case as a reasonable recovery period, since spikes in maintenance expenses can occur every three to four years. For example, the Company's Colstrip units have outages two out of three years; however, the CS2 unit (based on operating hours) typically has an outage every forth year. The four-year amortization period would generally fully amortize the costs of major maintenance of a unit, prior to the next major maintenance occurring for the same unit.

Q. Did you receive approval for deferred accounting treatment similar to that by this Commission in Docket No. UE-110876 in the Company's other electric jurisdiction?

A. Yes. The Idaho Commission approved in Case No. AVU-E- 11-01, the deferral of <u>operation</u> and maintenance expenses, with recovery of the deferral over a <u>three-year</u> period, as originally proposed by the Company in its direct filed case.

<u>**Tracking of Washington General Rate Case Expenses**</u>

Q. Order No. 6, approving the Settlement Stipulation in Docket Nos. UE-110876 and UG-110877, required Avista to begin tracking its Washington general rate case expenses. Has the Company fulfilled these requirements?

A. Yes. The Settlement Stipulation in Docket Nos. UE-110876 and UG-110877 agreed to by the parties specifically stated at Page 12, Paragraph 15:

> Avista agrees to begin separately accounting for all internal and external costs related to preparation, filing, and litigation of

> Washington general rate cases. The Company will present the overall amount of test year rate case expenses, including but not limited to internal labor costs, administrative and production costs, and costs of outside services, beginning with the 2012 test year.

Effective January 1, 2012, the Company began specifically tracking its electric and natural gas general rate case (GRC) activities in the State of Washington. To date, costs associated with internal and external costs related to preparation and filing of the 2012 GRC have been separately recorded. Future costs of responding to discovery requests and litigation activities will also be tracked. The 2012 costs are outside of the Company's historical test period filed in this case, which utilizes a 2011 test-year, and no additional GRC costs were pro formed in this case. The 2011 test period does include, however, embedded costs associated with the prior GRC. Beginning with the 2012 test year, any future GRC filings will include an identification of GRC expenses as part of the historical test period expenses.

<u>Internal Audit of 2011 Avista Utility Expenditures</u>

Q. Order No. 6, approving the Settlement Stipulation in Docket Nos. UE-110876 and UG-110877, required Avista to perform an internal audit of its accounting practices. Has the Company fulfilled these requirements?

A. Yes. The Settlement Stipulation in Docket Nos. UE-110876 and UG-110877 agreed to by the parties specifically stated, at page 12, Paragraph 15:

> Pursuant to the Commission's Final Order in Docket UE-100467 and UE-100468, Avista shall perform an annual internal audit for accounting practices in each of the three years following the issuance of that Final Order, and shall prepare a report regarding the results of

> such audit. The Company shall provide to the Parties the results of its annual audit(s), as well as all internal and external costs associated with performing the audit(s) and preparing the report(s).

The Company completed its first such audit of 2010 transactions and furnished the results to the Commission and all parties as part of its last GRC in Docket Nos. UE-100467 and UG-100468. Subsequently, the Company's Internal Audit (IA) Department completed its audit of 2011 expenditure transactions in March of 2012, at a total cost of $31,790.00, related to internal Company labor.[21] There were no other external costs associated with the 2012 audit.

This most-recent audit consisted of an internal audit of calendar year 2011 utility expenditures included in FERC accounts 400-935. The total population of transactions was just under 670,000 transactions (including revenues and expenses, debits and credits, between accounts 400-935). The population sampled totaled 301 transactions, and was deemed by the IA Department to be a sufficient sample size. The findings of this audit revealed 22 transaction errors, which were found to be incorrectly charged to the Utility or incorrectly assigned to service and jurisdiction. The majority of these errors (21) were found within the FERC account range 900-935, commonly referred to as A&G accounts, and totaled $12,529.90. A copy of the "Accounting Practices Audit" report has been included as Exhibit No. __(EMA-4)

Certain errors (3 errors) included in the IA audit were found by Rates Department personnel prior to completion of the Company's revenue requirement and were removed

[21] On March 28, 2012, the Company mailed the results of this most-recent audit report to the parties in Docket Nos. UE-100467 and UG-100468.

from the company's filing within its "Miscellaneous Restating" adjustment. However, as footnoted previously in my testimony, after the completion of the Company's revenue requirement calculation, additional changes in A&G expense, as a result of the additional 19 errors discovered during the process of the Company's internal audit of accounting practices and the additional errors found due to the subsequent review by Rates Department personnel for similar AI error transactions, were found. The total of the <u>additional</u> IA audit errors and the <u>additional similar</u> transactions found by Rates Department personnel would result in a decrease to electric expense of approximately $3,300.00 and an increase to natural gas expense of approximately $2,500.00. These additional changes in A&G expense, of course, will need to be reflected in the Company's final electric and natural gas revenue requirements approved in this case.

In addition, the IA Department also completed an audit of the Company's Low Income

Rate Assistance Program (LIRAP) expenditures, reviewing tariff rider revenues, allocation of revenues to Community Action Agencies, and expense transactions that occurred during the calendar year 2011. No errors were found as a result of this audit.

Q. As noted above, the majority of the errors (21) found within the Utility expenditure audit were found within the A&G accounts (900-935). Is it possible to extrapolate this error amount to the larger population of 670,000 transactions to arrive at a meaningful total of transactional errors?

A. No, it is not. As stated in the IA report (see Exhibit No.__(EMA-4), page 6):

As we performed an attribute sampling plan to determine the frequency of errors, materiality and dollar values were not taken into consideration. Further, as the allocations between service and jurisdiction vary, the dollar value of the errors in the population may also offset each other. Therefore, dollar value extrapolation of errors across the population is not feasible and each error must be assessed individually.

Q. How then can this Commission be assured that the Company has removed or corrected for errors outside of the audit sampling performed by the Company's IA Department?

A. The Company completed a review if its 2011 expenses included in its test period, removing expenses found to be charged to the Utility in error, or inaccurately allocated to the Washington electric and natural gas jurisdictions. This review resulted in the removal or reclassification of approximately $23,000 electric and $7,000 natural gas expenses from the Company's test period results, charged to the Utility in error (for costs related to dues, donations, sponsorships, miscellaneous employee expenses, non-utility airplane travel usage, etc.), as well as the reallocation of costs to properly reflect the correct service and jurisdiction of certain Washington electric and natural gas expenditures. An additional amount of $3,300.00 (reduction) to electric and $2,500.00 (increase) to natural gas A&G expense were found due to the IA's audit, which should also be removed.[22] The detail of these adjustments can be found within my workpapers labeled "Miscellaneous Adjustment" provided with the Company's filing.

Part way into the Company's 2011 test period utilized in this case, the Company

[22] The total of the transaction errors to be removed from the Company's 2011 historical test period results of, $26,600 electric ($23,000+$3,300) and $4,500 natural gas ($7,000-$2,500) is down substantially from the previous year's "Miscellaneous Restating" adjustment (in Docket Nos. UE-100467 and UG-100468) for these same types of costs of approximately $215,000 electric and $34,000 natural gas.

completed its Company-wide employee training on the Company's Regulatory Accounting Guidelines and Policies for affected employees, educating these employees on the appropriate use of FERC accounts, proper use of expense descriptions, certain new and existing accounting policies, and recording of utility versus non-utility expenditures. In addition, also in 2011, the Company began sending to all employees semiannually a written reminder to employees to properly label and record expenditures (including appropriate utility/non-utility, service and jurisdictional allocations).

During 2011, Rates Department personnel, as well as Corporate Accounting personnel, reviewed 2011 transaction activities through November 2011, notifying individual employees or departments of any questionable transactions, requesting they be reviewed and corrected if found inappropriately charged before year-end. This same review, for transactions through December 31, 2011, was subsequently completed by Rates Department personnel during the process of preparing the Company's calculation of its revenue requirement, resulting in the Miscellaneous Restating adjustment noted above.

Going forward, although the Company cannot guarantee (even if it was to incur significant cost to the Company and its customers in additional labor time), that errors for these types of costs or expenses will never occur (given the universe of 670,000 accounting transaction between Accounts 400-935), the Company believes it has, and continues to, take steps to minimize the accounting errors found in its test period results. This good faith effort is evident from the reduction in expenses needing removal from the Company's test period results.

Q. Did the Internal Audit report provide any observations regarding the Company's accounting practices?

A. Yes. The internal audit highlighted specific improvements that have been made by the Company in certain areas, as follows (See Exhibit No. __(EMA-4), page 5):

- Formal training was provided to the Company's employees and accounting guidelines were developed, communicated, and made available to all employees.

- Detective controls, including the review of specific accounts and expenditure types, were implemented in 2011.

- Experts within the Company were identified as a resource for employees to provide departments with guidance and support to ensure compliance with the Company's accounting guidelines.

- The Oracle iExpense module was modified to reject all expenses charged to FERC account 920 (Labor).

Q. Did the IA report identify any suggested recommendations to the Company for improvements of its accounting practices, and how will the Company respond to those specific recommendations?

A. Yes. The audit identified 4 recommendations for improvement of the Company's accounting practices, as shown at page 5 of Exhibit No. __(EMA-4). Each recommendation and Avista's responses are provided below.

1. We recommend the Company continue to provide formal training on the Company's accounting guidelines on an annual basis, which includes regulatory accounting and expense allocation guidelines, with a focus on purchase transactions (iExpense and vouchers). Formal training for new employees should be provided within a reasonable period of time after employment begins.

   Company Response: *The Company will continue to provide training on the allocation guidelines on an annual basis, requiring affected new* *employees, and affected employees with new positions within the Company to complete the training as needed.*

2. We recommend the Company annually remind department managers to review their listing of applicable projects/tasks (including service and jurisdiction allocations) to ensure they are accurate and reflective of the services provided by that department. Additionally, we recommend department managers provide this listing to employees as a reference tool for coding expenses.

   Company Response: *The Company will distribute a semi-annual written reminder to all department managers to review their listing of applicable projects/task and provide to their employees a reference tool for coding expenses to ensure that employees have access to the appropriate projects.*

3. We recommend the Company continue to design and implement additional detective controls to monitor compliance with the Company's accounting guidelines on a regular basis.

   Company Response: *The Company will continue to periodically monitor the accounting activity to determine compliance with the Company's Regulatory Accounting Guidelines and Policies.*

4. We recommend the Company communicate all identified errors from the 2011 Accounting Practices Audit to the employee submitting the expense and their supervisor to increase awareness about errors. Additional training should be provided if needed.

   Company Response: *The Company will communicate all identified errors from the 2011 Accounting Practices Audit to the employee submitting the expense and their supervisor to increase awareness about errors*.

VII. ALLOCATION PROCEDURES

Q. Have there been any changes to the Company's system and jurisdictional procedures since the Company's last general electric and natural gas cases, Docket Nos. UE-110876 and UG-110877?

A. No. For ratemaking purposes, the Company allocates revenues, expenses and rate base between electric and gas services and between Washington, Idaho, and Oregon jurisdictions where electric and/or gas service is provided. The annually updated allocation factors used in this case have been provided with my workpapers.

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

A. Yes, it does.