BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-06____

DIRECT TESTIMONY OF

RONALD L. MCKENZIE

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

Q. Please state your name, business address and present position with Avista Corporation ("Avista" or "Company").

A. My name is Ronald L. McKenzie and my business address is East 1411 Mission Avenue, Spokane, Washington. I am employed by Avista as Manager, Regulatory Accounting in the State and Federal Regulation Department.

Q. Would you briefly describe your educational background and professional experience?

A. I graduated from Eastern Washington University in 1973 with a Bachelor of Arts degree in Business Administration majoring in accounting. I joined the Company in September 1974. I obtained a Master of Business Administration Degree from Eastern Washington University in 1989. I have attended several utility accounting and ratemaking courses and workshops. I have held various accounting positions within the Company. I have served in the State and Federal Regulation Department for the majority of my career with the Company.

Q. Have you previously testified before this Commission?

A. Yes. I have testified before this Commission in several prior proceedings.

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

A. My testimony addresses the accounting associated with the power cost deferrals under the Energy Recovery Mechanism ("ERM") approved by the Commission in Docket No. UE-011595. I also explain what is contained in the monthly reports that are filed with the Commission. I also discuss the retail revenue credit portion of the ERM deferral calculation and the proposed rate to use for the credit.

Q. Are you sponsoring any exhibits?

A. Yes. I am sponsoring Exhibit No. ___(RLM-2), which consists of a copy of the November 2005 monthly ERM report for informational purposes.

II. ACCOUNTING ASSOCIATED WITH ERM DEFERRALS

Q. Would you please describe the accounting associated with the Company's ERM deferral mechanism?

A. Yes. Company witness Mr. William G. Johnson discusses in his direct testimony the current and proposed procedure to calculate the monthly variations between actual and authorized power supply revenues and expenses. Monthly variations are accumulated until the "Company Band" (deadband) of $9 million is exceeded. Once the deadband is exceeded, 90% of the monthly variation between actual and authorized net power supply costs is deferred. When actual net power supply costs exceed authorized costs, entries are made to record the deferral amount by crediting Account 557.28 - Other Power Supply Expenses, thereby decreasing recorded power supply expenses, and debiting Account 186.28 - Miscellaneous Deferred Debits. If actual net power supply costs are less than authorized costs in a given month, an entry is made to record the difference by debiting Account 557.28 - Other Power Supply Expenses, thereby increasing recorded power supply expenses, and crediting Account 186.28 - Miscellaneous Deferred Debits. An accumulated debit balance in Account 186.28 represents a surcharge balance, while an accumulated credit balance represents a rebate balance.

Q. Is more than one deferral account used to account for deferred power costs?

A. Yes. Account 186.28 - Miscellaneous Deferred Debits is used to account for power costs that are deferred in the current year, Account 186.29 - Miscellaneous Deferred

Debits contains the amount of deferred power costs from the previous year that are subject to review by the Commission for future recovery, and Account 182.35 – Regulatory Asset is used to account for the deferred power costs from prior years that have been approved by the Commission for recovery from customers.

At the beginning of the current year, the beginning balance in Account 186.28 is transferred to Account 186.29. Account 186.28 is then used to accumulate deferred power costs incurred in the current year. The balance in Account 186.29 represents deferred power costs from the previous year and those deferred costs remain in this account until the Commission determines in the Company's annual ERM review filing that the costs are recoverable. Once the Commission makes its determination, the deferred costs that are deemed to be recoverable are transferred from Account 186.29 to Account 182.35. Any costs that are deemed not recoverable are charged to expense.

Q. What are the balances in the three-deferral accounts at December 31, 2005?

A. Listed below are the balances in the three accounts at December 31, 2005:

Account 186.28 – Misc. Deferred Debits – Current Year Deferrals (2005)	$4,138,618
Account 186.29 – Misc. Deferred Debits – Prior Year Deferrals (2004)	$0
Account 182.35 – Regulatory Asset – Deferrals Authorized for Recovery	$92,052,195

Q. How is the monthly amortization related to surcharge revenue recorded?

A. Amortization of deferred power costs authorized for recovery in Account 182.35 is recorded monthly based on the amount of surcharge revenue for the month, adjusted for revenue related expenses. To record the amortization, Account 557.29 – Other Power Supply Expenses is debited and Account 182.35 is credited.

Q. How is interest recorded on the deferral balances?

A. Interest is calculated pursuant to the Settlement Stipulation approved by the Commission's Fifth Supplemental Order in Docket No. UE-011595 dated June 18, 2002. Interest is applied to the average of the beginning and ending month balances in Accounts 186.28, 186.29, and 182.35 net of associated deferred federal income tax. The Company's weighted cost of debt is used as the interest rate. The interest rate is updated semi-annually and interest is compounded semi-annually. The interest rate used for the period January 1, 2005 through June 30, 2005 was 8.28%, the Company's weighted cost of debt at December 31, 2004. The interest rate used for the period July 1, 2005 through December 31, 2005 was 8.12%, the Company's weighted cost of debt at June 30, 2005.

Q. How are income taxes accounted for under the deferred power cost mechanism?

A. The power cost deferral entries are not recognized in the determination of taxable income for federal income tax purposes. Therefore, deferred federal income taxes are recorded. Account 283.28 – Accumulated Deferred Federal Income Tax reflects a credit balance of 35% of the debit balances in Accounts 186.28, 186.29, and 182.35. When Account 283.28 is credited, Account 410.10 – Deferred FIT Expense in debited. Likewise, when Account 283.28 is debited, Account 410.10 is credited.

III. ERM MONTHLY AND ANNUAL REPORTS

Q. Would you please describe the monthly reports that the Company submits to the Commission?

A. The Company submits monthly reports to the Commission, Public Counsel, and ICNU that include the monthly power cost deferral journal entries together with backup workpapers and other supporting documentation. The cover letter to the monthly report contains a brief explanation of the factors causing the variance between actual and authorized power costs. The beginning of the month account balances, the recorded activity within the accounts, and the ending month account balances are shown. The January and July reports contain the supporting workpapers for the semi-annual updates of the weighted cost of debt used in the interest calculations. The monthly reports also include any new power contracts of one-year or longer entered into during the month. Attached as Exhibit No. ___(RLM-2) is a copy of the November 2005 report for informational purposes.

Q. Is the Company also required to make an annual filing to review deferrals?

A. Yes. The Company is required to make an annual filing on or before April 1 of each year regarding the power costs deferred in the prior calendar year under the ERM. The filing consists of testimony, exhibits, and supporting documentation. Since its inception in 2002, the Company has made three such annual filings, and will be submitting its next filing on or before April 1 of this year.

Q. What is the review period for the annual ERM filing?

A. The Commission Staff and interested parties have the opportunity to review the deferral information during a 90-day review period ending June 30th each year. The 90-day review period may be extended by agreement of the parties participating in the review, or by Commission order.

Q. When was the last annual ERM filing addressed by the Commission?

A. The annual ERM filing covering the 2004 calendar year was reviewed in Docket No. UE-050492. Order No. 01 was issued in that docket on June 29, 2005, and the Commission found that the power cost deferrals for 2004 were prudent.

IV. ERM REVENUE CREDIT

Q. Why is a retail revenue credit included in the ERM deferral calculation?

A. Actual power supply costs are impacted by actual retail load requirements. Since the ERM tracks the difference between actual and authorized power supply costs, it is also necessary to include a retail revenue credit as an offset to the change in power supply costs. The ERM deferral calculation includes a retail revenue credit adjustment in order to account for this offset.

If, for example, actual retail loads are greater than authorized loads, then the Company collects additional revenue and incurs increased power costs to serve the increased load. The retail revenue credit provides an offset to the increased power costs so that the costs aren't collected twice: once through increased retail revenue, and again, through an ERM surcharge to recover increased power costs. The reverse is also true. If actual retail loads are less than authorized loads, then the Company collects less revenue and incurs reduced power costs to serve the reduced load. In this example the retail revenue credit is necessary so that the Company does not experience both a reduction in retail revenue, and also pass through to customers, in the ERM, a reduction in power supply costs.

Q. What issue was raised in the recent general rate case regarding how to determine the retail revenue credit rate?

A. The cost of service study is used to determine the amount included in retail revenue related to the recovery of production-related costs. The amount of production-related costs, expressed as a cost per kilowatt-hour, is the rate used for calculating the retail revenue credit. The issue that was raised in the recent general rate case is whether to exclude or include an allocation of common administrative and general costs in determining the retail revenue credit rate.

Q. How did the Commission address the retail revenue credit rate issue in its last rate order?

A. In Docket No. UE-050482 the issue was discussed in paragraphs 78-80, beginning on page 35, of Order No. 5 dated December 21, 2005. The Commission determined that the issue should be considered in the near-term review of the ERM. The Commission also determined that the retail revenue credit can be adjusted at any time prior to the end of 2006 with the new credit applying for the entire year 2006.

Q. Should the common administrative and general costs be included in the retail revenue credit rate?

A. No. The costs to be used in determining the retail revenue credit should include only those directly assigned production costs that are incurred to meet the load requirements of retail customers. An allocation of common administrative and general costs to production-related costs artificially inflates the value of production-related costs and should not be included.

Q. How much difference does excluding or including an allocation of common administrative and general costs have on the retail revenue credit rate?

A. Paragraph 78 at page 35 of Order No. 5 identifies a retail revenue credit rate of 3.399 cents per kilowatt-hour without an allocation of common costs, and 3.739 cents per kilowatt-hour with an allocation of common costs. These amounts were based on the Company's original rate increase filing of $35.8 million. Based on the final approved electric revenue increase of $21,387,000, the retail revenue credit rate becomes 3.289 cents per kilowatt-hour without an allocation of common costs, and 3.619 cents per kilowatt-hour with an allocation of common costs. The difference between the retail revenue credit rates, excluding and including an allocation of common costs, is 0.330 cents per kilowatt-hour.

Q. Please describe the costs that are directly assigned to production-related costs and are used to derive the retail revenue credit rate.

A. Production-related costs used to derive the retail revenue credit rate include:

a) Operating and maintenance expenses included in FERC Accounts 500 to 557.

b) Directly assigned administrative and general expenses based on charges by responsibility area.

c) Depreciation and amortization expense related to production.

d) Production-related operating revenue other than retail revenue.

e) Taxes other than income related to production.

f) Income tax directly assigned to production based on rate base.

g) Revenue related expenses – excise tax, commission fees, and uncollectibles assigned to production.

h) Return on production-related rate base.

Q. Please describe the costs that are included in the common administrative and general expense category.

A. Costs that are included in the common administrative and general expense category include:

a) Common administrative and general expenses in FERC Accounts 920 to 935, excluding expenses directly assigned to the production, transmission, or distribution categories. These costs include administrative and general salaries, office supplies and expenses, outside services, property insurance, injuries and damages, pensions and benefits, regulatory commission expenses, miscellaneous expenses, rents, and maintenance of general plant.

b) Depreciation and amortization expense related to general plant and intangible plant not directly assigned to the production, transmission or distribution categories.

c) Taxes other than income - property tax associated with general plant.

d) Income tax directly assigned to common based on common rate base.

e) Revenue related expenses – excise tax, commission fees, and uncollectibles assigned to common.

f) Return on common rate base – general and intangible plant not directly assigned to the production, transmission or distribution categories.

The items shown above clearly fall into the common administrative and general expense category and are not related to the function of producing or acquiring power for utility customers.

Q. What is the retail revenue credit rate that was used in ERM deferral calculations prior to the conclusion of the recently approved electric general rate case?

A. The retail revenue credit used in ERM deferrals prior to the conclusion of the recently approved general rate case was 3.208 cents per kilowatt-hour and included an allocation of common administrative and general costs. This compares to the new retail revenue credit rate of 3.289 cents per kilowatt-hour that the Company is requesting be adopted in this case and that excludes an allocation of common administrative and general costs.

Q. Did a Company witness address the common administrative and general cost issue in the recently concluded general rate case?

A. Yes. Company witness Tara Knox addressed the issue in Docket No. UE-050482. She created a separate functional category for common costs in both her electric and gas cost of service studies. She noted that administrative and general costs that cannot be directly assigned to the other functions were placed in the common cost category. In developing the retail revenue credit in that case, Ms. Knox excluded this common administrative and general cost category so that the rate for the revenue credit would appropriately reflect only the directly assigned administrative and general costs.

Q. How were common administrative and general expenses allocated to rate classes within the Company's cost of service study?

A. Most common and administrative expenses (Accounts 920-935) were allocated to rate classes by operation and maintenance expenses excluding purchased power, fuel, wheeling, and revenue items. Property insurance for common general plant was allocated by plant totals. Injuries and damages and pensions and benefits expenses were allocated by operating and maintenance labor expense totals.

Q. Does the fact that the allocation of common administrative and general expenses to rate classes was based on production, transmission, and distribution expenses mean that a portion of the allocated common expenses should then be classified as being production-related?

A. No. Allocated common administrative and general expenses should not be classified as being production-related, transmission-related, or distribution-related. The method used to allocate the common costs to rate classes does not change the nature of the costs; they are still common costs. The allocation method is used to allocate the common costs to rate classes, not to allocate the common costs to production, transmission, and distribution cost categories.

Q. Does the fact that purchased power, fuel, wheeling and revenue items are excluded from the costs used to allocate common administrative and general expenses demonstrate that there isn't a relationship between these costs?

A. Yes. The fact that there is a separate classification of "common" administrative and general costs indicates that there is not a relationship of these common costs to the production, transmission, or distribution cost categories. In addition, the exclusion of the indicated power supply-related costs from the allocation factor applied to common administrative and general expense indicates that there is not a relationship between the excluded power supply costs and common administrative and general costs.

Purchased power, fuel, and sales for resale revenue are net costs that are tracked through the ERM. Common administrative and general expenses bear no relationship to these costs that are tracked through the ERM.

Q. Would you please summarize the reasons for adopting the Company's proposed retail revenue credit rate of 3.289 cents per kilowatt-hour?

A. Yes. Only directly assigned production costs should be used for determining the retail revenue credit rate. An allocation of common administrative and general costs to production-related costs artificially inflates the value of production-related costs and should not be included. The method used to allocate common costs to rate classes does not change the nature of the costs; they are still common costs. Common administrative and general costs are not related to production costs or to power supply costs that are tracked through the ERM.

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

A. Yes, it does.