Exhibit No. ___(MPG-1T)
Docket Nos. UE-150204/UG-150205
Witness: Michael P. Gorman

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

| | | |
|---|---|---|
| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br><br>Complainant,<br><br>v.<br><br>AVISTA CORPORATION, DBA AVISTA UTILITIES,<br><br>Respondent. | ) | DOCKET NOS. UE-150204 and UG-150205 *(Consolidated)* |

**RESPONSE TESTIMONY OF MICHAEL P. GORMAN**

**ON BEHALF OF**

**NORTHWEST INDUSTRIAL GAS USERS**

**July 27, 2015**

**TABLE OF CONTENTS TO THE**
**RESPONSE TESTIMONY OF MICHAEL P. GORMAN**

**Page**

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

**A.** Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

**Q. WHAT IS YOUR OCCUPATION?**

**A.** I am a consultant in the field of public utility regulation and a managing principal of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

**Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.**

**A.** These are set forth in Exhibit No. ___(MPG-2).

**Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

**A.** I am appearing on behalf of the Northwest Industrial Gas Users ("NWIGU").

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

**A.** I will respond to the revenue requirement and attrition study methodology proposed by Avista witness Elizabeth M. Andrews for Avista's gas operations.

## I. SUMMARY

**Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS ON AVISTA'S REVENUE DEFICIENCY.**

**A.** In my testimony, I take issue with the Company's claimed revenue deficiency in this proceeding. First, as describe below, the Company's filing shows that no increase is justified based on the Company's year-end 2014 cost of service projections. At year-end 2014, Avista's study shows a revenue surplus of $215,000. Hence, no change in natural gas rates is justified in this case. Second, I will comment on the unreasonableness of the Company's proposed attrition methodology. Third, in the event the Commission accepts this methodology, I propose adjustments to the

Company's revenue requirement based on this methodology. If the attrition methodology proposed by Avista is relied upon, it should be corrected and reduced from $12 million to $6.69 million, based on Avista's filed case.

**Q PLEASE EXPLAIN WHY THE COMPANY'S PROPOSED ATTRITION METHODOLOGY IS NOT AN APPROPRIATE MEANS OF DEVELOPING A REVENUE REQUIREMENT FOR SETTING RATES.**

**A.** The Company's attrition methodology produces a cost of service which are not known and measureable estimates of the Company's actual cost of providing service during the period rates will be in effect. The Company's use of historical escalation and operating cost and invested capital balances to project cost going forward simply ignores the known and measurable standard. As such, rates should be set based on verifiable and known and measureable cost of providing to utility customers

## II. ATTRITION METHODOLOGY

**Q. PLEASE DESCRIBE THE COMPANY'S PROPOSED REVENUE REQUIREMENT DEFICIENCY AND METHODOLOGY FOR ITS GAS OPERATIONS.**

**A.** The Company is proposing an attrition methodology to adjust its actual results of operation on September 31, 2014 through year-end 2016. In its original filing, the Company requested an overall rate of return of 7.46% and an increase in revenues of $12.1 million for gas operations. NWIGU, along with other parties, entered into a Multiparty Settlement Stipulation which settled, subject to Commission approval, cost of capital and other issues.

Avista developed its claimed revenue deficiency on Ms. Andrews' Exhibit No. EMA-3. On that exhibit, she begins with actual results of operation on September 31,

2014, and makes projections for changes to cost of service to year-end 2014, and then uses attrition escalator adjustments to project the Company's cost of service year-end 2016.

As shown on my attached Exhibit No. ___(MPG-3), based on its original filing, this methodology shows that Avista has a revenue surplus at year end 2014 of $215,000 (Column E page 3) , and the attrition methodology increasing Avista's claimed gas revenue deficiency from $6 million on September 31, 2014 (column A) , to a surplus at year end 2014 ( Column E) and up again to a $12.1 million revenue deficiency by year-end 2016 ( Column K).

**Q. DOES THE COMPANY IDENTIFY SPECIFIC POLICY REASONS WHY IT BELIEVES ITS ATTRITION YEAR ADJUSTMENTS ARE REASONABLE?**

**A.** Yes. Avista argues that its rate base investments continue to grow over time, and the attrition year methodology provides the Company a better opportunity to mitigate regulatory lag and adjust rates to its cost of service. Ms. Andrews refers to the National Association of Regulatory Utility Commissions ("NARUC") manuals in support of the Company's proposed attrition methodology. She states that the NARUC manual discusses the use of a future historical test year which is intended to represent the Company's cost of service for future rates. She goes on to recite differences between historical and future test years, and concludes the revenue requirement produced in customer rates using a future historical test year will be just fair and reasonable and sufficient.

**Q. HAS THE COMPANY'S ATTRITION METHODOLOGY BEEN ADOPTED BY THE WASHINGTON COMMISSION IN PRIOR RATE CASES?**

**A.** No. In Avista's last rate case, the Commission did accept a settlement by the parties to adjust rates, but the parties did not agree on the use of an attrition adjustment in the determination of the revenue requirement.

**Q. PLEASE EXPLAIN WHY YOU BELIEVE THE CURRENT REGULATORY PROCEDURES USED BY THE WASHINGTON COMMISSION STRIKE A FAIR BALANCE BETWEEN UTILITIES AND THEIR CUSTOMERS.**

**A.** Consistent with regulatory mechanisms used throughout the U.S., and supported by NARUC, the Washington utility regulatory mechanisms are balanced because they ensure utilities' rates are set to reflect reasonable and prudent known and measurable costs of providing utility services. With this standard, customers are given price signals that reflect the cost of providing utility services, which allow them to make efficient consumption decisions. This practice also provides economic incentives for utilities to aggressively manage costs, and for customers to aggressively consider options to modify demands on the utility system to reduce the utility's cost so the utility can minimize its cost of service.

Setting rates using a known and measurable standard also provides adequate transparency to ensure that utilities are not overstating their cost of service, to inflate profits and/or cash flow by inflating utility prices. Just as importantly, this regulatory standard has been used in Washington and has supported investment grade utilities, with strong access to capital, and provided customers the assurance that they are paying rates no higher than necessary to provide recovery of reasonable and prudent cost of utility services.

## III. PROPOSED ATTRITION METHODOLOGY IS NOT REASONABLE

**Q. PLEASE EXPLAIN WHY YOU BELIEVE AVISTA'S PROPOSED ATTRITION METHODOLOGY IS NOT REASONABLE.**

**A.** Avista's proposed attrition methodology is not reasonable for the following reasons:

1. It is an imbalanced methodology that is proposed by Avista now only because it is in an elevated capital expenditure period of its business cycle. Avista has benefitted from traditional ratemaking earlier, and now its proposal to modify it is not balanced and does not produce a consistent and predictable regulatory policy that can be used by all stakeholders to make business decisions.

2. Avista can control and mitigate regularity lag because it controls the timing and frequency of its rate filings.

3. Regulatory lag will be mitigated over time without distorting the current balanced regulatory practices in Washington. Even with continued elevated capital expenditures, the impact on Avista's rate base growth will be mitigated over time and traditional ratemaking practices will continue to provide a fair balance between Avista's investors and its customers.

4. Regulatory principles and policies in Washington have been recognized by credit rating agencies as reasonably supportive. Therefore, there is no legitimate reason to modify these principles now. Doing so is imbalanced between customers and shareholders.

5. The imbalance in Avista's methodology is evident by a comparison of the results of the attrition methodology in this case, to verifiable cost elements Avista has shared with the investment community.

## III.A. Balanced Regulatory Policy

**Q. PLEASE EXPLAIN WHY THE EXISTING REGULATORY POLICY NEEDS TO BE PREDICTABLE AND BALANCED IN ORDER TO ENCOURAGE INVESTMENT BY AVISTA AND ITS CUSTOMERS.**

**A.** Both Avista and its customers need to understand the regulatory practices of the Washington Utilities and Transportation Commission ("WUTC" or "Commission") in order to make business decisions and support capital expenditure in Washington. Avista needs to understand these practices to understand capital investment timing, and cost recovery procedures. Similarly, business customers rely on traditional and

predictable regulatory practices in order to forecast the cost of utility rates in order to review the economics of making capital investments in their own Washington facilities.

To the extent the Commission modifies its historical balanced regulatory practices, the economic justification relied on by businesses for capital investments can be distorted and erode the economic justification for making capital investments, which can distort non-regulated companies' willingness to make capital investments in Washington. A predictable regulatory policy and practices therefore benefit the utility and its investors, and customers of the utility and their investors.

**Q. PLEASE EXPLAIN WHY MODIFICATION OF HOW THE COMMISSION REGULATES UTILITIES IS NOT NECESSARY IN ORDER TO SUPPORT A BALANCED REGULATORY TREATMENT FOR THE UTILITY AND CUSTOMERS.**

**A.** Washington utilities' main concern with current regulatory practices is their ability to adjust rates to reflect changes in their cost of service between a historical test year and the rate-effective period. This is largely driven by increases in rate base. The levels of capital investments for utilities are cyclical. Capital investments can be lower during periods, and will increase to elevated levels during periods of infrastructure modernization or during meeting new environmental compliance or renewable resources. Utilities can manage this because they control the timing and frequency of rate filings

During the elevated capital investment periods, rate base will grow by capital additions increasing the utility rate base. Use of traditional ratemaking practices in Washington can limit the utilities' ability to adjust rates fast enough in order to recognize changes in rate base, unless of course a utility files frequent rate

proceedings, a strategy Avista has used in recent history. However, elevated capital investment periods and rate base growth are typically a temporary phenomenon. Specifically, as utilities increase capital investments and grow their embedded rate base, a large capital program will start to slow their rate base growth over time which then will be supported by more traditional rate-setting practices to recognize that increased capital spend.

**Q. CAN YOU PROVIDE AN EXAMPLE OF HOW UTILITIES' RATE BASE GROWTH WILL SLOW OVER TIME EVEN IF THE LEVEL OF CAPITAL INVESTMENT STAYS ELEVATED?**

**A.** Yes. The ability of a utility to adjust rates to reflect an increasing rate base due to elevated capital expenditures will mitigate over time simply by increasing the embedded rate base of the utility. This is shown in Table 1 below by tracking the percent increase in utility rate base. As the rate base increases at a larger percent increase, the ability to set rates using traditional ratemaking may create some regulatory lag in setting rates, which is mitigated by a utility's ability to control the timing and frequency of its rate filings. However, as the embedded rate base increases, even with a continued elevated capital expenditure program, the growth in rate base will decline over time.

**TABLE 1**

**Rate Base Growth**

**Elevated Capital Spend**

| Period | Gross Plant In-Service (1) | Accumulated Depreciation (2) | Capital Investment (3) | Year-End Net Plant Rate Base (4) | Depreciation Expense (5) | Rate Base Growth (6) |
|---|---|---|---|---|---|---|
| 1 | $100,000 | ($1,250) | | $98,750 | $2,500 | |
| 2 | $107,500 | ($3,844) | $7,500 | $103,656 | $2,688 | 5.0% |
| 3 | $115,150 | ($6,627) | $7,650 | $108,523 | $2,879 | 4.7% |
| 4 | $122,953 | ($9,603) | $7,803 | $113,350 | $3,074 | 4.4% |
| 5 | $130,912 | ($12,776) | $7,959 | $118,136 | $3,273 | 4.2% |
| 6 | $139,030 | ($16,151) | $8,118 | $122,880 | $3,476 | 4.0% |
| 7 | $147,311 | ($19,730) | $8,281 | $127,581 | $3,683 | 3.8% |
| 8 | $155,757 | ($23,518) | $8,446 | $132,239 | $3,894 | 3.7% |
| 9 | $164,372 | ($27,520) | $8,615 | $136,852 | $4,109 | 3.5% |
| 10 | $173,160 | ($31,739) | $8,787 | $141,421 | $4,329 | 3.3% |
| 11 | $182,123 | ($36,180) | $8,963 | $145,943 | $4,553 | 3.2% |
| 12 | $191,265 | ($40,848) | $9,142 | $150,418 | $4,782 | 3.1% |
| 13 | $200,591 | ($45,746) | $9,325 | $154,845 | $5,015 | 2.9% |
| 14 | $210,102 | ($50,879) | $9,512 | $159,223 | $5,253 | 2.8% |
| 15 | $219,805 | ($56,253) | $9,702 | $163,551 | $5,495 | 2.7% |
| 16 | $229,701 | ($61,872) | $9,896 | $167,829 | $5,743 | 2.6% |
| 17 | $239,795 | ($67,741) | $10,094 | $172,054 | $5,995 | 2.5% |
| 18 | $250,091 | ($73,864) | $10,296 | $176,226 | $6,252 | 2.4% |
| 19 | $260,592 | ($80,248) | $10,502 | $180,345 | $6,515 | 2.3% |
| 20 | $271,304 | ($86,897) | $10,712 | $184,408 | $6,783 | 2.3% |

Depreciation Rate: 2.5%
Capital Spend Inflation: 2.0%
Elevated Capital investment: 7.5% of Initial Gross Plant, growth limited by human and financial capital

Table 1 above illustrates that rate base growth will decrease over time even with the continued elevated capital expenditure program. This is important because it illustrates the need to maintain the current regulatory policy in Washington. Changes in rates need to track known and measurable changes in plant and cost of service. Hence, as capital expenditure programs initially ramp up, the utilities' rate base will grow at a faster rate, and utilities file more frequently to adjust rates to reflect that increased plant investment. However, over time, the need for frequent rate filings is

mitigated because rate base growth slows even if capital expenditures remain at an elevated level. Accordingly, to the extent extraordinary rate treatment is needed, the utility can demonstrate it and file to increase rates.

**Q. WHY IS THIS IMPORTANT IN ASSESSING THE NEED TO CHANGE THE WUTC'S RATE-SETTING PRACTICES?**

**A.** Because cyclical investment patterns can impact relative growth in rate base differently over various points of the business cycle, changes in regulatory policy must consider the entire investment business cycle of the utility and the relative impact on customers throughout that cycle. During times of significant capital investment and rate base growth, the WUTC has seen settlements between utilities and their customers to produce rate schedules that support the utility's ability to make capital investments. Therefore, the Washington Commission's current regulatory practice, including adjudication and allowing utilities and stakeholders to negotiate rate settlements to recognize the change in utilities' cost structure during the period rates will be in effect, is a balanced and predictable practice. Adjusting the regulatory policy as Avista proposes would distort the regulatory compact and is unfair to rate payers. As such, no change is necessary to Washington's current regulatory practices.

**Q. YOU ALSO MENTIONED THAT CREDIT RATING AGENCIES HAVE NOTED THAT WASHINGTON REGULATORY PRACTICES ARE REASONABLY SUPPORTIVE. PLEASE CITE THE EVIDENCE YOU HAVE OF THESE CREDIT RATING FINDINGS.**

**A.** Both Standard & Poor's ("S&P") and Moody's have recognized that Washington adjusts rates in a balanced manner. They both acknowledge that Avista's last rate settlement was constructive for the utility, and clearly was something acceptable to the other stakeholders in the process. S&P rates Avista Corp. as A- with a "Stable"

outlook. Moody's has a bond rating of Baa1 for Avista's issuer rating, also with a "Stable" outlook.

S&P states the following:

> **Outlook: Stable**
>
> The stable outlook reflects our expectation that the company will continue to effectively manage regulatory risks, fund capital spending in a manner that does not meaningfully increase leverage, preserve adequate liquidity, and maintain comparable financial performance. Under our base case scenario we expect funds from operations (FFO) to total debt of 16%.
>
> **Downside scenario**
>
> We could lower the rating if business risk would materially rise or credit measures diminished such that FFO to debt would be consistently below 13%. Causes could include greater borrowing or increased rate lag, a large deferral, or adverse regulatory decisions.
>
> **Upside scenario**
>
> We could raise the rating if the business risk greatly improves or financial measures strengthen to levels including FFO to debt over 23%.[1]

Moody's also finds that Avista's regulatory treatment has been supportive. Moody's states the following:

> **Summary Rating Rationale**
>
> Avista's Baa1 issuer rating reflects its low-risk business profile as a vertically integrated electric utility in supportive regulatory jurisdictions, which allows the company to produce fairly predictable cash flow year-over-year. The rating also considers increasing capital expenditures focused on transmission and

[1] *Standard & Poor's RatingsDirect*: "Summary: Avista Corp.," May 9, 2014, Workpapers of Avista witness Adrien M. McKenzie, AMM Page 70 of 890, emphasis added.

> distribution improvements, which are of a lower risk profile than some regional peers of the same rating.[2]

In support of this conclusion about Avista's credit outlook, Moody's makes positive statements concerning the rate settlement entered into with the stakeholders in its last rate case.

The comments from S&P and Moody's illustrate the constructive regulatory treatment by the WUTC and the constructive interaction between Avista and its stakeholders in negotiating balanced rate settlements. This is critical to ensure that the balance is not disturbed such that Avista would not need to negotiate constructive rate settlements with customers in the future. Therefore, its proposed attrition methodology should not be adopted, but rather Avista should continue to work with its stakeholders and the Commission in order to reach constructive and balanced rate decisions.

**Q. IS THERE INFORMATION THAT INFORMS THE INVESTMENT COMMUNITY ABOUT THE SUPPORT OF THE WASHINGTON JURISDICTIONS FROM AN INVESTOR STANDPOINT?**

**A.** Yes. In at least two instances, the state of Washington's regulatory treatment is considered supportive of investing in infrastructure and supporting utilities' ability to fund that infrastructure investment. For example, S&P in a report titled "Utility Regulatory Assessments for U.S. Investor-Owned Utilities," categorizes the Washington Commission in the "Strong/Adequate" assessment of the regulatory environment in Washington. Based on S&P's review, Washington falls into the second most investor supportive category, where a majority of the state jurisdictions

---

[2] *Moody's Investors Service*: "Credit Opinion: Avista Corp.," March 28, 2014, Workpapers of Avista witness Adrien M. McKenzie, AMM Page 76 of 890, emphasis added.

fall. Similarly, SNL Financial rates the Washington Commission "Average/2." SNL's ranking ranges from a below average ranking (with subgroup notches between 1 and 3 with 1 being the highest), to an "Above Average" industry ranking. Washington's ranking of "Average/2" is consistent with most of the utilities in SNL's universe.[3]

**Q. YOU ALSO STATED THAT THERE IS EVIDENCE THAT THE ATTRITION METHODOLOGY WILL OVERSTATE AVISTA'S BUDGETED COST. PLEASE EXPLAIN.**

**A.** I have compared Ms. Andrews' projected plant additions for the Washington jurisdiction, relative to the Company's announcements of capital expenditures for gas utility operations for all of its jurisdictions (Washington, Idaho and Oregon). This comparison shows that the projected plant additions Ms. Andrews made for Washington using the attrition methodology exceed the Company's planned capital investments for all of its jurisdictions. Hence, her attrition methodology is highly inexact and imbalanced because it does not properly match attrition level capital investments, with the capital investments the Company actually plans to make.

**Q. DO YOU BELIEVE THAT MS. ANDREWS' ATTRITION METHODOLOGY FOR GAS OPERATION MEETS THE NARUC STANDARD?**

**A.** No. There are several highly questionable results and projections made by Ms. Andrews which puts into question whether or not the resulting attrition methodology results in rates that are just and reasonable, and whether the rates are no more than adequate to provide recovery of the Company's cost of service while the rates are in effect.

---

[3]SNL Financial website (www.snl.com/interactivex/CommissionProfiles.aspx). A printout will be included in Mr. Gorman's workpapers.

Specifically, the NARUC manual states that a future test year adjustment to rates should reflect costs that are known and measurable or reasonably estimated.

Ms. Andrews' attrition projections simply cannot be verified and corroborated as reasonable. For example, a comparison of the Company's capital budget for total gas operations and Ms. Andrews' attrition plant projections for Washington illustrates this imbalance. For example:

1. Ms. Andrews' projections in plant addition during the last quarter in 2014 amount to $22.8 million. The projected plant additions from the year-end 2014 through year-end 2016 amount to $28.3 million. The accuracy of these estimates of Avista's plant additions during this time period are highly questionable.

2. Ms. Andrews' attrition methodology adjusts costs to year-end 2016. It would have been more appropriate to have adjusted attrition cost to an average amount rather than a year-end amount.

**Q. PLEASE EXPLAIN WHY YOU BELIEVE MS. ANDREWS' PROJECTIONS FOR PLANT ADDITION ARE INCONSISTENT WITH THE COMPANY'S CLAIMED CAPITAL EXPENDITURES.**

**A.** In a report to shareholders published on June 2015, at "Position for Performance: and overview of Q1 2015 and beyond," Avista at page 8 of its presentation investors included projections for capital expenditures over the period of 2014 through 2017. In its management presentation, Avista lists its planned capital expenditures for its gas utility operation to be $23 million in 2014, $39 million in 2015, $26 million in 2016, and $23 million in 2017. These capital expenditures are for total Avista gas utility operations which includes its Idaho, Oregon and Washington jurisdiction. However, Ms. Andrews' projected capital additions for the State of Washington alone exceeds these planned capital expenditures by Avista.

Specifically, on her Exhibit No. EMA-3, she projects $22.8 million of capital expenditures in the third quarter of 2014 which nearly equals the full calendar year

projected capital expenditures by Avista for all three jurisdictions. Further, for the periods 2015 and 2016, Avista's planned capital expenditures are $65 million for total Company operations, compared to Ms. Andrews' projections of $68.3 million for the Washington jurisdiction alone.

While the Washington jurisdiction is its largest for Avista's gas operations, it is not reasonable to assume that more than 100% of the total Company's planned capital expenditures will be made in the Washington jurisdiction. As such, Ms. Andrews' projected capital additions are simply not reasonable. Therefore, they fail to meet the standards she outlines at the beginning of her testimony for adjusting rates to reflect reasonable prudent cost of service.

**Q. PLEASE EXPLAIN WHY MS. ANDREWS' PROPOSED USE OF YEAR-END PROJECTED PLANT ADDITIONS IS NOT REASONABLE.**

**A.** Putting the Company's rates into effect at the beginning of 2016, and adjusting rates to reflect a rate of return on year-end plant balances results in rates that are higher than necessary to recover Avista's cost of service for plant in service throughout the year. Specifically, Avista's use of a future test year is typically based on an average year plant balance, not end of year. This is appropriate because it ensures that Avista does not earn a greater rate of return on its plant in service than what is actually in service throughout the year. As such, Ms. Andrews projected additions for 2016 are overstated because they should have been based on an average year convention not an end of year convention.

**Q. CAN YOU PROVIDE AN EXAMPLE TO ILLUSTRATE WHY AN AVERAGE YEAR RATE BASE BALANCE WILL MORE ACCURATELY ESTIMATE THE UTILITY'S INVESTED CAPITAL COST?**

**A.** Yes. A simple illustration will help explain why estimating the annual interest cost on an average investment balance will more accurately estimate Avista's actual rate year cost of capital. Consider a simplified example using a bank account to prove this point.

In this bank account, the depositor had an initial balance at the beginning of the year of $100 and makes a $100 deposit to the account at the end of each month. Hence, in month 2 the beginning balance is $200 and so on throughout the end of year. By the end of year the account balance is $1,200.

The bank pays interest on the account at an annual rate of 12%, or a monthly rate of 1% (12% = 12 months). The monthly amount of interest income is calculated based on the balance of the account in the month times the monthly interest rate.

**TABLE 2**

**Annual Return Example**

| Month | Beginning of Month Balance (1) | End Of Month Deposit (2) | Interest (3) | Interest Rate (4) |
|---|---|---|---|---|
| 1 | $100 | $100 | $1 | 1.0% |
| 2 | $200 | $100 | $2 | 1.0% |
| 3 | $300 | $100 | $3 | 1.0% |
| 4 | $400 | $100 | $4 | 1.0% |
| 5 | $500 | $100 | $5 | 1.0% |
| 6 | $600 | $100 | $6 | 1.0% |
| 7 | $700 | $100 | $7 | 1.0% |
| 8 | $800 | $100 | $8 | 1.0% |
| 9 | $900 | $100 | $9 | 1.0% |
| 10 | $1,000 | $100 | $10 | 1.0% |
| 11 | $1,100 | $100 | $11 | 1.0% |
| 12 | $1,200 | | $12 | 1.0% |
| Annual Interest | | | $78 | 12.0% |
| Avg. Annual Balance | $ 650 | | | |
| Annual Return | $78/$650 | equals | 12.0% | |

The interest earned each month is shown under Column 3 based on a monthly interest rate of 1%, and the account balance in Column 1. The amount of interest earned on the account throughout the year is $78. The average monthly balance for the 12-month period is $650. The annual interest of $78 divided by the average balance on the account equals the 12% stated interest rate on the account. Stated differently, applying the annual rate of return, 12%, on the annual average account balance, $650, will correctly estimate the actual interest earned on the account of $78 ($650 x 12%).

In significant contrast, if the annual interest were calculated based on the end-of-year balance of $1,200, then the estimate of the account's annual interest would be $144, a clear overstatement of the account's actual earnings. Using the end-of-year balance will overstate the account balance in 11 months of the 12-month annual period.

This illustration clearly shows that Avista will over-recover its cost of capital if it uses an end-of-year rate base instead of an average year rate base. As such, Avista would recover more than its actual prudent and reasonable cost of service within the test year if its rate base methodology is not corrected to reflect an average rate base.

## IV. ADJUSTED ATTRITION STUDY

**Q. IF THE COMMISSION ACCEPTS AVISTA'S ATTRITION METHODOLOGY, CAN MS. ANDREWS' ATTRITION ADJUSTMENT BE MODIFIED IN ORDER TO PRODUCE A MORE REASONABLE ESTIMATE OF ITS REVENUE DEFICIENCY BASED ON HER OVERSTATEMENT OF PLANT INVESTMENTS IN THE FOURTH QUARTER OF 2014, AND REFLECT AN AVERAGE YEAR CONVENTION FOR 2016?**

**A.** Yes. In the event the Commission accepts Avista's attrition methodology, Ms. Andrews' plant addition should be adjusted as follows:

1. Ms. Andrews' projections for reduction in sales for the forecast period is not based on an acceptable normalization study, or forecast of billing units with a number of customers. Therefore, her projected decline in the revenue's current rate should not be used.

2. Her escalation factors for plant addition should be adjusted to reflect a mid-year 2016 test year, instead of an end of the year construct. Therefore, her escalations for plant in service depreciation expense and accumulated depreciation should all be reduced by 25% reduction based on her proposal to forecast these cost of four quarters to year-end 2016. 75% of the escalator would forecast the plants out the mid-year 2016 from the end of 2014.

3. Ms. Andrews' projections for increases in depreciation and amortization expense should also be reduced from 24.1% down to 11.67%. The 11.67% increase represents the estimated escalation in gross plant which must tie directly in with an increase to depreciation expense.

4. Ms. Andrews' escalator for O&M expenses should be reduced to a 1.5-year escalator from a 2.25-year escalator as she reflects in her study. This revised escalator will reduce the escalation of expenses from the 6.88% escalator used by Ms. Andrews down to 4.53%. Revising the escalator in this manner reduces the escalation to a mid-year 2016 test year, from the post-2016 test year based on the 2.25-year escalator used by Ms. Andrews.

**Q. WITH THESE PROPOSED CHANGES IN THE ESCALATION OF PLANT COSTS, ARE THE ATTRITION BASE PLANT PROJECTIONS MORE IN LINE WITH THE MANAGEMENT REPORTED CAPITAL EXPENDITURES FOR GAS UTILITIES?**

**A.** Yes. With these adjustments, the fourth quarter plant additions are $5.7 million which is approximately one-fourth of the $22 million 2014 annual capital expenditure budged by Avista. These capital additions are more in line with the full year capital expenditure projection made by Avista management to investors of $20 million for this year.

The escalation in plant additions for 2015 and 2016 is approximately $49.2 million for retail operations in Washington. This represents approximately 76% of the capital expenditures expected to be made in 2015 and 2016 on a total Avista gas utility basis (including Washington, Idaho and Oregon).

**Q. HOW WOULD AVISTA'S GAS REVENUE DEFICIENCY BE IMPACTED WITH THESE ADJUSTMENTS?**

**A.** Again, Avista's own cost study at year end 2014 shows that a revenue deficiency does not exist. However, using the attrition methodology as proposed by Avista, as shown on my attached Exhibit No. ___(MPG-3), with my proposed adjustments, Avista's revenue deficiency decreases from around $12 million as estimated by Avista, down to $6.69 million.

**Q. DOES THIS CONCLUDE YOUR RESPONSE TESTIMONY?**

**A.** Yes, it does.