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8 BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION
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10 DOCKET NO. UE-99______
DOCKET NO. UG-99______
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12 DIRECT TESTIMONY OF DON M. FALKNER
REPRESENTING THE AVISTA CORPORATION
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WUTC
DOCKET NO. UE-991606
EXHIBIT # T-226
ADMIT W/D REJECT

Exhibit T-26

1 Q. Please state your name, business address, and present position with Avista
2 Corp.
3 A. My name is Don M. Falkner. My business address is East 1411 Mission
4 Avenue, Spokane, Washington. I am employed by Avista Corp. (Company) as a Senior
5 Rate Accountant.
6 Q. Would you please describe your education and business experience?
7 A. I graduated from Washington State University in February of 1981 with a
8 Bachelor of Arts Degree in Business Administration majoring in Accounting. That same
9 year, I passed the May Certified Public Accountant exam and joined The Company in June.
10 I have served in various positions within the sections of the Finance Department, including
11 Power Supply Accounting, Subsidiary Accounting, Budget and Forecasting, Plant
12 Accounting and Corporate Accounting. For the past 9 years, I have served in the Rates and
13 Tariff Administration Section, which is part of the Company's External Relations
14 Department.
15 Q. As a Senior Rate Accountant, what are your responsibilities?
16 A. As a Senior Rate Accountant, aside from special projects, I am responsible
17 for preparation of normalized semi-annual Commission Basis reporting in the various
18 jurisdictions in which the Company provides utility services. I also have been the lead rate
19 analyst in the Company's most recent general rate filings.
20 Q. What is the scope of your testimony in this proceeding?
21 A. I will be presenting the Company's overall revenue requirement and my
22 testimony and exhibits in this proceeding will generally cover accounting and financial data
23 in support of the Company's need for the proposed increase in rates. I will explain pro
24

1 formed operating results including expense and rate base adjustments made to actual
2 operating results and rate base. The pro forma net operating income and rate base that serve
3 as the basis for the overall revenue requirement in this filing incorporate not only those
4 adjustments prepared by myself, but also by Company Witnesses Hirschkorn, Norwood,
5 Mitchell and DeFelice. I will cover each of those adjustments briefly while their
6 testimonies will provide more in-depth discussions. My testimony will also cover the
7 system and jurisdictional allocations used in preparation of the Company's pro forma results
8 of operations study presented in this proceeding.

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

10 A. Yes. I am sponsoring Exhibit No(s). 27, 28, 29, 30 and 31, as previously
11 marked for identification, which were prepared under my supervision and direction.

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

13 A. The test period being used by the Company is the twelve-month period
14 ending December 31, 1998 presented on a pro forma basis.

15 Q. What is the Company's rate of return that was last authorized by this
16 Commission for its electric operations in Washington?

17 A. The Company's currently authorized rate of return (ROR) for its Washington
18 electric operations is 10.67%. That rate dates back to Case No. UE-900093, which became
19 effective on July 1, 1990.

20 Q. Have there been any changes to base electric rates in the Washington
21 jurisdiction since 1990?

22 A. No. The Company has not changed its base, or general Washington electric
23 rates for over 9 years. However, a Demand Side Management Tariff Rider (Tariff Rider)
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was implemented January 1, 1995 in which a surcharge of 1.5% is being used to fund energy efficiency improvements.

Q. Does the Tariff Rider have any impact on the normalized level of Company earnings for its Washington jurisdiction?

A. No. The revenue generated by the Tariff Rider has a matching expense associated with it. The bottom line, or net operating income impact is zero, so there is no earnings impact. The actual management of the program disbursements is done through a balance sheet account.

Q. What has been the Company's experienced earnings levels since the rate change associated with Case No. UE-900093?

A. Other than the first year, 1991, the Company has consistently earned below its last authorized level of 10.67%. Also, as can be seen in the chart below, the Company's Washington jurisdictional ROR has been consistently declining since 1995. As I mentioned earlier, one of my main responsibilities is preparation of a semi-annual jurisdictional electric report that is required in Washington. These reports are prepared on a "Commission Basis." Commission Basis means that rate base includes standard rate base components that have historically been accepted by the Commission for ratemaking. Additionally, the Company's booked results of operations are adjusted to a ratemaking basis by normalizing weather impacts on revenues and power supply and eliminating out-of-period items, nonrecurring items or any other item that would materially distort the test period's results. The final result is a restated rate of return for the reporting period. A historical review of the Company's filings with the Commission show that the Company's electric operations have been earning less than its last authorized rate of return for a number

1 of years. Even though the Company is aware that many things have changed in the
2 financial markets since its last general case in Washington, a history of the normalized
3 returns that the Company has filed with the Commission will still provide some perspective.
4 Below is that history.
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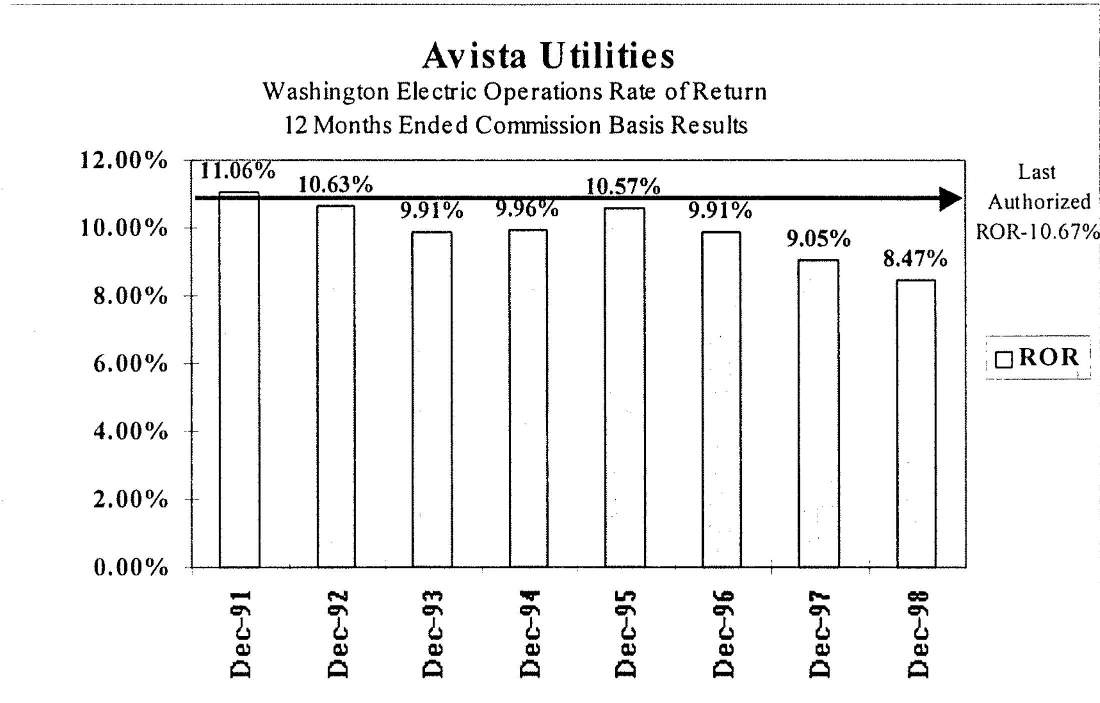

Q. Is there one main issue that contributed to the requested increase?
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A. No. There is no one single item responsible for the requested increase.
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Obviously, not having had a general rate case for over 9 years has contributed to the rate
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pressure. Using information from the Semi-Annual Reports that we have been filing with
19
the Commission since 1990, average electric customers in our Washington jurisdiction have
20
risen from 176,700 to 201,600, or slightly over 14% from 1990 through the end of 1998.
21
As one might expect over this time period, all cost categories have increased, including
22
power supply, distribution, customer accounting and administrative and general.
23
Depreciation rates are also being updated in this case. Plus, a settlement agreement signed
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1 in 1998 and implemented February 1999, that addresses the long-term negotiations related
2 to relicensing of two of the Company's hydro generating facilities, resulted in added costs.
3 Q. Are there rate pressures associated with the customer growth?
4 A. Yes. The physical plant known as Distribution plant has increased by 47%.
5 It should be noted that there are system enhancements and other non-line extension
6 infrastructure expenditures included in the functional group called Distribution. Comparing
7 Semi-Annual Report information for Washington electric operations in 1990 and now in
8 this filing, on a per customer basis, Distribution plant has risen from $1,398 to $1,801, or a
9 29% increase. What results is a higher percentage of total distribution plant being
10 comprised of newer, higher cost plant. The following chart that illustrates Distribution
11 plant and average customers over the period of years we have been supplying the Semi-
12 Annual reports to this Commission:
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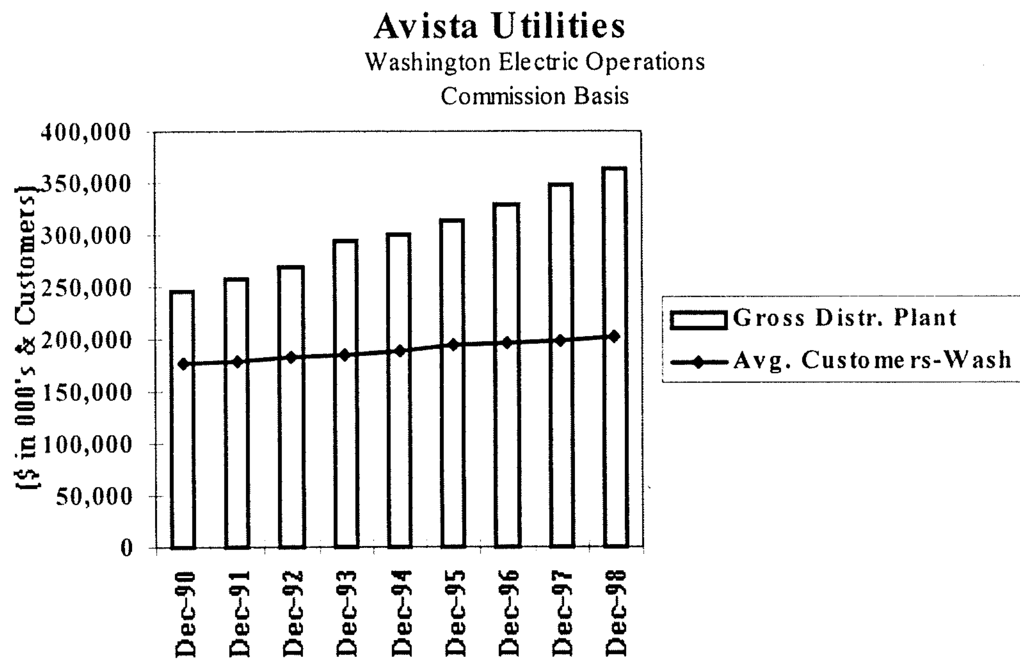
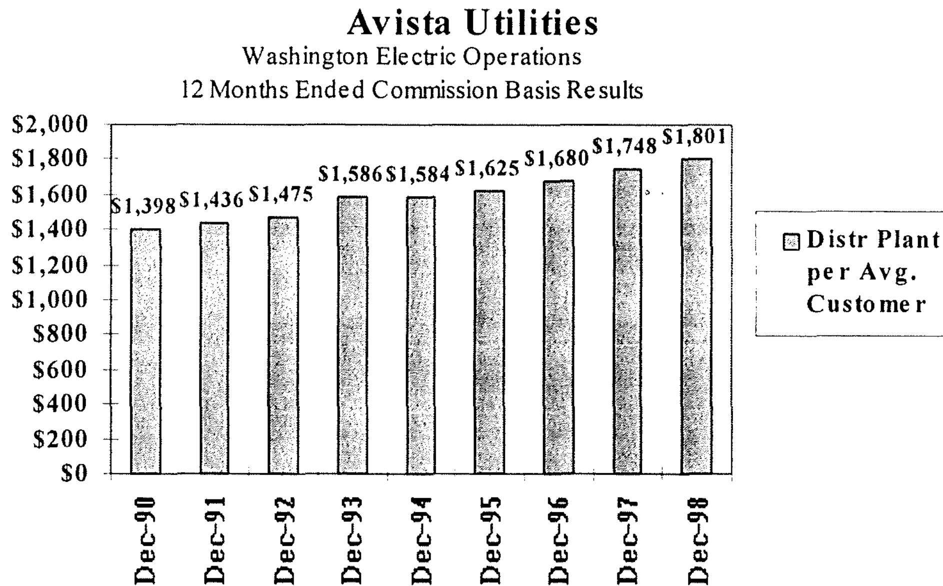


Distribution plant per average customer is illustrated below:



Q. Have there been corresponding increases in Distribution related expenses?

A. Yes. Again using Semi-Annual Report information, Distribution expenses, on a per customer basis, have increased from $144 in 1990 to $165 in 1998, or 15%. This increase illustrates the impact of inflation, more than that of customer growth. Looking at strictly the nominal dollar increase in Distribution expense shows an increase of 31% versus a 14% increase in actual customer count.

ALLOCATION PROCEDURES

Q. Referring to what has been marked as Exhibit No. 27, would you explain what is included in this exhibit?

A. Yes. Exhibit No. 27 is an explanation of the allocation procedures used for revenues, expenses and rate base. For ratemaking purposes, the Company must allocate

1 revenues, expenses and rate base between electric and gas services and between
2 Washington, Idaho, Oregon and California jurisdictions where electric and/or gas service is
3 provided.
4 Q. Have allocation procedures changed since the last time the Company
5 changed general electric rates?
6 A. Yes. Since the last time the Company changed general electric rates, the
7 Company acquired natural gas operating properties in Oregon and California. New
8 procedures for allocating common costs and common general plant were developed in
9 conjunction with the Staffs of all four state jurisdictions. The Commission Staff performed
10 a preliminary analysis of the Company's new methodology for assigning and allocating
11 common costs between services and jurisdictions.
12 Q. What was the result of the Staff's preliminary review?
13 A. In a letter to the Company, Staff stated that they agreed in concept and found
14 the new methodology to be reasonable, while at the same time they reserved the right to
15 audit and fully scrutinize the proposals in the first general rate case application the
16 Company submits to this Commission. The new methodology was implemented at the start
17 of 1994.
18 Q. Has the Staff had an opportunity to review the actual allocations
19 since they were implemented in 1994?
20 A. Yes. The Company has filed reports with the Commission every 6 months
21 on a "Commission Basis," as explained earlier in my testimony. These reports have
22 reflected the new allocation since 1994. The Company's 1997 gas case, Docket No. UG-
23 971071, resulted in a settlement agreement between the Company, Staff and intervenors.
24

REVENUE REQUIREMENT

Q. Now, handing you what has been marked as Exhibit No. 28, for identification, would you please outline what is shown in this exhibit?

A. Yes. Exhibit No. 28 shows actual and pro forma electric operating results and rate base for the test period for the Company's Washington jurisdiction. Column (b) of page 1 of Exhibit No. 28 shows twelve months ended December 31, 1998 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 pro forma results of operations, all under existing rates. Column (e) shows the revenue increase required which would allow the Company an opportunity to earn a composite 9.97% rate of return. Column (f) reflects pro forma electric operating results with the requested increase of $26,253,000.

Q. Why do you refer to the 9.97% rate of return as a composite?

A. In this filing, the Company is requesting an overall rate of return of 9.93% for its electric and gas rate base, with the exception of the Company's wood-waste fired Kettle Falls Generating station. The Company is requesting that a 2% equity incentive, as allowed by state statutes for renewable resource projects, be applied to the component of the electric rate base made up of the Kettle Falls plant's average net investment. Witness Dukich will address this issue in more detail. The impact of the 2% incentive raises the requested weighted rate of return of 9.93% to an effective, or composite rate of return of 9.97%.

1 Q. Would you please explain page 2 of Exhibit No. 28?

2 A. Yes. Page 2 shows the calculation of the $26,253,000 revenue requirement.
3 The Total Net Operating Income Requirement for the Company is the sum of the Kettle
4 Falls Plant average net plant at 10.87% rate of return and the balance of the electric rate
5 base at the at the requested 9.93% rate of return. The difference between the two rates of
6 return is the impact of the 2% equity incentive. Also shown is the calculation of the Kettle
7 Falls rate base component.

8 Q. Would you now please explain page 3 of Exhibit No. 28?

9 A. Yes. Page 3 shows the derivation of the net operating income to gross
10 revenue conversion factor. The conversion factor takes into account uncollectible accounts
11 receivable, Washington State Excise Tax and Franchise Fees. Federal income taxes are
12 reflected at 35%.

13 Q. Now turning to pages 4 through 9 of your Exhibit No. 28, for identification,
14 would you please explain what is shown by those pages?

15 A. Yes. Page 4 begins with actual operating results and rate base for the test
16 period in column (b). Individual normalizing adjustments that are standard components of
17 our semi-annual reporting to the Commissions begin in column (c) on page 4 and continue
18 through column (u) on page 7. Column (v) on page 7, entitled Restated Total, is the
19 subtotal of all preceding columns. Individual pro forma and additional normalizing
20 adjustments begin in column (PF1) on page 8 and continue through column (PF10) on page
21 9. These adjustments are either refined calculations of adjustments that are usually included
22 as components of our semi-annual reporting, e.g. the Power Supply adjustment, or
23 adjustments that are unique to this general rate filing, e.g. the Hydro Relicensing
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1 adjustment. Column (PF11) is the final pro forma operating results and rate base for the
2 test period.
3
4 **COMMISSION BASIS ADJUSTMENTS**
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6 Q. Would you please explain each of these adjustments, the reason for the
7 adjustment and its effect on test period state of Washington net operating income and/or
8 rate base?
9 A. Yes. The first adjustment, column (c) on page 4, entitled Deferred FIT Rate
10 Base, reflects the rate base reduction for Washington's portion of deferred taxes. The
11 adjustment reflects the deferred tax balances arising from accelerated tax depreciation
12 (Accelerated Cost Recovery System, ACRS, and Modified Accelerated Cost Recovery,
13 MACRS), bond refinancing premiums, and contributions in aid of construction. The effect
14 on state of Washington rate base is a reduction of $100,720,000.
15 Column (d), Deferred Gain on Office Building, reflects the rate base reduction for
16 Washington's portion of the net of tax, unamortized gain on the sale of the Company's
17 general office facility. The facility was sold in December 1986 and leased back by the
18 Company. The effect on state of Washington rate base is a reduction of $1,150,000.
19 Column (e), Colstrip 3 AFUDC Elimination, is a reallocation of rate base and
20 depreciation expense between jurisdictions. In Cause Nos. U-81-15 and U-82-10, the
21 Washington Utilities and Transportation Commission (WUTC) allowed the Company a
22 return on a portion of Colstrip Unit 3 construction work in progress (CWIP). A much
23 smaller amount of Colstrip Unit 3 CWIP was allowed in rate base in Case U-1008-144 by
24

1 the Idaho Public Utilities Commission. The Company eliminated the AFUDC associated
2 with the portion of CWIP allowed in rate base in each jurisdiction. Since production
3 facilities are allocated on the Production/Transmission formula, the allocation of AFUDC is
4 reversed and a direct assignment is made. These amounts are a component of actual results
5 of operations. The effect on state of Washington net operating income is an increase of
6 $208,000. The effect of the reallocation on state of Washington rate base is a decrease of
7 $3,736,000.

8 The adjustment in column (f), Colstrip Common AFUDC, is also associated with
9 the Colstrip plants in Montana, and increases rate base. Differing amounts of Colstrip
10 common facilities were excluded from rate base by the IPUC and this Commission until
11 Colstrip Unit 4 was placed in service. The Company was allowed to accrue AFUDC on the
12 Colstrip common facilities during the time that they were excluded from rate base. It is
13 necessary to directly assign the AFUDC because of the differing amounts of common
14 facilities excluded from rate base by the IPUC and this Commission. In September 1988,
15 an entry was made to comply with a Federal Energy Regulatory Commission (FERC) Audit
16 Exception which transferred Colstrip common AFUDC from the plant accounts to account
17 186. These amounts reflect a direct assignment of rate base for the appropriate average of
18 monthly average amounts of Colstrip common AFUDC to the Washington and Idaho
19 jurisdictions. Amortization expense associated with the Colstrip common AFUDC is
20 charged directly to the Washington and Idaho jurisdictions through Account 406. These
21 amounts are a component of the actual results of operations. The effect on state of
22 Washington rate base is an increase of $746,000.

23 The adjustment in column (g), Kettle Falls Disallowance, decreases rate base. The
24

1 amounts reflect the Kettle Falls generating plant disallowance ordered by this Commission
2 in Cause No. U-83-26. This Commission disallowed both a return of and a return on
3 $5,247,725 of investment in Kettle Falls. The disallowed investment and related
4 depreciation expense, FIT expense, accumulated depreciation and deferred FIT are
5 removed. These amounts are a component of actual results of operations. The effect on
6 state of Washington net operating income is an increase of $108,000. The effect of the
7 disallowance on state of Washington rate base is a decrease of $1,841,000.
8 Q. Please turn to page 5 and explain the adjustments shown there.
9 A. Column (h), Clearwater Hydro, reflects the rate base addition for the
10 unamortized portion of costs expended by the Company for the termination of a proposed
11 hydro electric site. The Company would have been required to contract for the output of the
12 project under federal guidelines. At an open business meeting on October 25, 1989, the
13 Commission approved the deferral and ten-year amortization of termination costs associated
14 with Clearwater Hydro. These amounts reflect the rate base amounts, net of deferred taxes,
15 related to Clearwater Hydro termination. These amounts are a component of actual results
16 of operations. The effect on state of Washington rate base is an increase of $28,000.
17 A. Column (i), Weatherization and DSM Investment, includes in rate base
18 balances (net of amortization) of weatherization grants, the model conservation program
19 costs and electric demand side management (DSM) program costs. The Company ceased
20 accruing AFUCE and began full amortization beginning August 1994. These amounts are a
21 component of actual results of operations. The effect on state of Washington rate base is an
22 increase of $26,551,000.
23 Q. Would you please explain how energy efficiency-related expenditures
24

1 impact the revenue requirement in this case?

2 A. Yes. The unamortized balance of energy efficiency management investment
3 incurred prior to 1995 is included in the results of operations and becomes a rate base item
4 in the column (i) adjustment just described. DSM expenditures incurred after January 1,
5 1995 have been and will continue to be offset by revenues from the Company's energy
6 efficiency tariff rider, Schedule 91, and are not included in the revenue requirement.
7 Witness Folsom is sponsoring additional testimony regarding the Company's expenditures
8 for energy efficiency programs.

9 Q. Please continue with your explanation of the adjustments on page 5.

10 A. The adjustment in column (j), Customer Advances, decreases rate base for
11 funds advanced by customers for line extensions as they will most likely be recorded as
12 contributions in aid of construction at some future time. The effect on state of Washington
13 rate base is a decrease of $1,361,000.

14 The adjustment in column (k), Settlement Exchange Power, reflects the net
15 operating income requirement associated with the recovery of 64.1% of the Company's
16 investment in Settlement Exchange Power. The 64.1% recovery level was approved by the
17 Commission's Second Supplemental Order in Cause No. U-86-99 dated February 24, 1987.
18 Amortization expense and deferred FIT expense recorded during the test period are
19 removed and the net operating income requirement approved in Cause No. U-86-99 is
20 incorporated. These amounts are a component of actual results of operations. The effect on
21 state of Washington net operating income is a reduction of $4,332,000.

22 The column marked by a dash, and immediately following column (k), subtotals
23 columns (b) through (k) and represents actual operating results and rate base plus the
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1 standard rate base adjustments that are included in Commission Basis reporting, but not
2 generally calculated in the Company's monthly jurisdictional Results of Operations reports.
3 Column (l), Eliminate B & O Taxes removes the revenues and expenses associated
4 with local business and occupation taxes. The adjustment eliminates any timing mismatch
5 that exists between the revenues and expenses by eliminating the revenues and expenses in
6 their entirety. This restating adjustment is consistent with the column (w) adjustment
7 included in the stipulation in Docket No. UE-900093. B & O Taxes are passed through on
8 a separate schedule which is not being updated as part of this proceeding. The effect of this
9 adjustment is to decrease state of Washington net operating income by $38,000.
10 Q. Please turn to page 6 and explain the adjustments shown there.
11 A. Column (m), Pro Forma Property Tax, restates the 1998 test period accrued
12 levels of property taxes to the actual amounts. The effect of this particular adjustment is to
13 increase Washington net operating income by $83,000.
14 Column (n), Uncollectible Expense, restates the accrued expense to the actual level
15 of net write-offs for the test period. The effect of this adjustment is to decrease Washington
16 net operating income by $21,000.
17 Column (o), Regulatory Expense Adjustment, restates booked 1998 regulatory
18 expense to reflect the WUTC assessment rates applied to revenues for the test period. The
19 effect of this adjustment is to decrease Washington net operating income by $80,000.
20 Column (p), Injuries and Damages, is a restating adjustment that replaces the accrual
21 with the six year rolling average of actual injuries and damages payments not covered by
22 insurance. A six year rolling average and the reserve method of accounting for injuries and
23 damages, net of insurance proceeds, is a practical methodology to deal with these normal
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1 utility operating expenses that happen to occur on an irregular basis and differ markedly in
2 materiality. As a result of the WUTC's Order in Docket No. U-88-2380-T, the Company
3 changed to the reserve method of accounting for injuries and damages not covered by
4 insurance for both its electric and gas systems and conformed the methodology in both
5 jurisdictions. The effect of this adjustment is to decrease Washington net operating income
6 by $1,514,000.
7 Q. Does the Company include the effects of extraordinary circumstances such
8 as the Firestorm of 1991 and the Ice Storm of 1996 in the regulatory accrual for injuries and
9 damages?
10 A. Yes. Both events, net of insurance proceeds, are included in the adjustment
11 that is filed in the Commission Basis reporting. The amounts for both events are directly
12 assigned to jurisdictions. Firestorm costs are only assigned to the Washington jurisdiction.
13 The Ice Storm component is also directly assigned to jurisdictions and impacts both states.
14 Q. Does the Company propose to handle all storm damage costs through the
15 injuries and damages accrual?
16 A. No. Some level of storm damage related expense is contained in virtually
17 every test period for the Company and no changes are being proposed to adjust those test
18 period costs. However, the storm damage costs included in the injuries and damages
19 accrual are legitimate expenditures that do impact a utility's operations from time to time.
20 A six year rolling average of these non-insured costs of a utility is a reasonable vehicle for
21 recognizing the necessity of these expenditures, while at the same time "smoothing" the
22 potential recovery of these costs over a period of time. The Company included its intended
23 handling of the accounting, and associated potential recovery, in its report to the
24

1 Commission entitled, " Ice Storm '96 Overview—Two Months Later."

2 Q. What did the Company say in that report?

3 A. In section 3.7 Costs and Recovery, on page 14, the Company stated, "...The
4 remaining $17.1 million ($11.1 million after-tax) will be included with other non-insured
5 losses from storms and accidents. The annual expense level is determined through use of a
6 six-year average. WWP will not seek a specific rate surcharge due to the costs of Ice Storm
7 '96 restoration."

8 Q. Please continue your explanation of the adjustments found on page 6.

9 A. Column (q), entitled FIT, is required to reflect the appropriate level of
10 federal income tax expense for the test period. This adjustment removes the effect of
11 certain Schedule M items, matches the jurisdictional allocation of other Schedule M items
12 to related Results of Operations allocations, eliminates any prior period income tax expense,
13 and amortizes audit adjustment payments over a two year period. The normal audit cycle is
14 an audit every two years covering two years of returns. This adjustment also reflects the
15 proper level of deferred tax expense for the test period. The effect of this adjustment, all
16 based upon a Federal tax rate of 35%, is to decrease Washington net operating income by
17 $3,230,000.

18 Column (r), entitled Pro Forma Debt Interest, restates debt interest using the
19 Company's pro forma weighted average cost of debt, as outlined in the testimony and
20 exhibits of Witness Avera and applied to Washington's pro forma level of rate base, plus
21 construction work in progress to produce a pro forma level of tax deductible interest
22 expense. The Federal income tax effect of the restated level of interest for the test period
23 decreases Washington net operating income by $2,128,000.

24

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

2 A. Column (s), Eliminate A/R Expenses, A/R representing Accounts
3 Receivable, removes expenses associated with the sale of customer accounts receivable.
4 This restating adjustment is consistent with the Commission's Third Supplemental Order in
5 Docket No. U-88-2380-T. The effect of this adjustment is to increase Washington net
6 operating income by $973,000.

7 Column (t), Office Space Charged to Subs, removes a portion of the office space
8 costs (building lease and O&M costs, common area costs, copier expense and annual office
9 furniture rental) using the percentage of labor dollars charged to subsidiary activities by
10 employee compared to total labor dollars by employee. These percentages are applied to
11 the employees' office space (expressed in square feet) and multiplied by office space
12 costs/per square foot. This restating adjustment is made as a result of the Commission's
13 Third Supplemental Order in Docket No. U-88-2380-T which required the company to
14 perform a space utilization study to allocate costs to subsidiaries. Due to the Company's
15 efforts at segregating subsidiary activities, this adjustment has historically been a relatively
16 small adjustment. The effect of this adjustment is to increase Washington net operating
17 income by $16,000.

18 Column (u), Reclass DADs/MOPs Revenues, reclassifies revenues for the
19 Company's two experimental deregulation programs. Billed revenues for the two programs
20 had been recorded into account 456, Other Revenues, for internal tracking purposes.
21 Technically, they are tariffed general business revenues, so they are reclassified here to
22 facilitate the preparation of the revenue adjustment which will be discussed later. This
23 reclassification has zero effect on Washington net operating income.

24

Column (v), entitled Restated Total, subtotals all the preceding columns (b) through column (u), exclusive of the previously discussed subtotal column. These totals represent actual operating results and rate base plus the majority of the standard normalizing adjustments that the Company includes in its semi-annual Commission Basis reports. Notable exceptions to the list of standard Commission Basis adjustments, up to this point, are three pro forma adjustments (PF1, PF2 and PF8). Those are the power supply adjustment, the Potlatch contract adjustment and the revenue adjustment. Those adjustments, which will be discussed later by myself and Witnesses Hirschkorn and Norwood, have been produced in more detail and were based upon a different pro forma period than were originally prepared for the Commission Basis reports.

PRO FORMA AND ADDITIONAL NORMALIZING ADJUSTMENTS

Q. Please turn to page 8 and explain the significance of the 10 columns subsequent to column (v) that begin on that page in your Exhibit No. 28.

A. Certainly. All adjustments subsequent to column (v) are signified by a PF with an identifying digit, 1 through 10. These adjustments bring the operating results and rate base to the final pro forma level for the test period. They contain the standard pro forma and normalizing adjustments included in a general rate filing, but not generally included in, or prepared in more detail than in the Company's Commission Basis filings. Additionally, they include adjustments that recognize the jurisdictional impacts of material items that will impact the pro forma operating period.

Q. Please continue with your explanation of the adjustments on page 8.

A. Column (PF1), entitled Pro Forma Power Supply 7/00-6/01, was made under the direction of Mr. Norwood and is explained in detail in his testimony. This adjustment normalizes power supply related revenue and expenses to reflect the twelve month period July 1, 2000 through June 30, 2001. The effect of the power supply adjustments as described by Witness Norwood on a system basis, decreases the state of Washington net operating income by $450,000.

Column (PF2), entitled Pro Forma Potlatch-7/00-6/01, synchronizes portions of the Potlatch Contract revenues that are dependent upon non-firm rates with the non-firm rates determined by the Company's dispatch model and utilized in the Pro Forma Power Supply adjustment. Additionally, monthly service charges are escalated to the charge that by contract would be in place during that period. The effect of this adjustment is to increase Washington net operating income by $683,000.

Column (PF3), Pro Forma Depreciation Adjustment, reflects an increase in depreciation expense due to the utilization of new depreciation rates that were the result of a detailed depreciation study performed by a consultant from Deloitte & Touche, LLP. This adjustment also eliminates the out-of-period annual depreciation expense true-up adjustment for 1997 and adds in the true-up for 1998 that was recorded in 1999. The Company last changed its depreciation rates on January 1, 1990. Witness DeFelice is sponsoring this adjustment and will explain it in more detail. The effect of this adjustment is to decrease Washington net operating income by $2,861,000 and to decrease Washington rate base by $1,431,000.

Column (PF4), entitled Pro Forma Relicensing Cost Adjustment, reflects inclusion

of the annual operating expense portions in pro forma results of operations for an agreement, signed in December of 1998 and implemented in February of 1999, that settles all stakeholder issues associated with relicensing of certain of the Company's hydroelectric facilities on the Clark Fork River. Also, the adjustment contains amortization of "collaborative" costs that had been capitalized during the process. Witness Anderson will provide a detailed background of the relicensing process and also discuss the ongoing administration of the settlement agreement.

Q. How is the Company proposing that these costs, the capitalized process costs and the annual settlement amounts, be handled for ratemaking?

A. The Company is proposing that process costs be amortized over the expected 45 year license request. This produces an annual amortization for the process costs of $328,700 on a system basis. Additionally, the Company is requesting that the scheduled incremental O&M portion of the Clark Fork Settlement Agreement be included for recovery at the levelized amount of $1,862,000 on a system basis. Both costs are to be allocated based upon the Production/Transmission formula.

Q. What is the effect of this adjustment on test period state of Washington net operating income and rate base?

A. The effect on state of Washington net operating income is a decrease of $954,000 and an increase in rate base of $9,277,000.

Q. As Witness Anderson will later explain, the Clark Fork Settlement is a "flexible" contract. Is the Company proposing any special accounting treatment to address the potential for mismatch between recovery and expense associated with the O&M level of Settlement cost authorized in this case?

1 A. Yes. I am proposing that a balancing account be utilized to capture the
2 differences between the O&M level of Settlement costs ultimately allowed in rates and the
3 amounts that get expended on an annual basis. FERC Account 253, Other Deferred Debits,
4 would accumulate a running balance that would represent either a regulatory asset or a
5 regulatory liability. Credit entries to the account would be made for the amount of O&M
6 that is being recovered in current rates. Debit entries would be made to the account for
7 actual O&M expenditures made pursuant to administration of the Settlement. The
8 Company proposes that any balance in the Hydro Relicensing deferred balancing account
9 would be subject to refund or surcharge and be addressed in the Company's next general
10 rate case, or if necessary, be a separate filing if no general case is filed in the next three
11 years. Exhibit 29 uses a simple example to show proposed entries for the balancing
12 mechanism.
13 Q. Does this balancing account "guarantee" the Company recovery of the O&M
14 level of the Settlement?
15 A. No. In regards to the Credit entries for the expense recognition that I
16 mentioned earlier, I am recommending that they be recorded at the actual level authorized
17 in this proceeding. The Company's case is predicated upon a normalized test year level of
18 customer sales. With the Credit, or liability, entries to the account being made based upon
19 the authorized recovery level, the Company will be at risk for the variability between actual
20 sales and the normalized test year.
21 Q. What are you proposing in regards to Settlement expenditures that are capital
22 in nature?
23 A. Capital expenditures associated with the Settlement are not a component of
24

1 this filing. Future capital expenditures would be handled as normal plant-in-service
2 additions and would not technically be included in customer rates until some future general
3 rate proceeding includes them.

4 Q. Please continue with your discussion of the remaining adjustments on page 8
5 of your testimony.

6 A. Column (PF5), entitled Pro Forma Comm Trade, removes costs associated
7 with commercial electric brokering activities performed by the Company that are unrelated
8 to serving embedded retail loads. Witness Norwood explains this adjustment in detail. The
9 effect of this adjustment is to increase Washington net operating income by $199,000.

10 Column (PF6), entitled Pro Forma Nez Perce Adjustment, reflects an increase in
11 Production operating expenses. An agreement was entered into between the Company and
12 the Nez Perce Tribe (Tribe) to settle certain issues regarding earlier owned and operated
13 hydro electric generating facilities of the Company. This agreement results in certain
14 expenses that were not included in test period results of operations.

15 Q. Could you provide a brief history of the development of this agreement?

16 A. Certainly. On December 6, 1991, an action was initiated by the Tribe
17 against the Company associated with the Company's operation of two hydro electric
18 facilities that provided power to customers during the period of 1937 to 1973. The two
19 facilities were known as the Grangeville Dam and the Lewiston Dam, both on the
20 Clearwater River in Idaho. The Grangeville Dam and the Lewiston Dam were both
21 ultimately demolished, in 1963 and 1973, respectively. Certain claims were made by the
22 Tribe revolving around impacts of the dams on fishing. As a result of an extensive legal
23 process, coupled with a productive mediation process, the Company reached an agreement
24

1 in principle with the Tribe that served as a framework for an enforceable settlement which
2 was executed by both parties in 1999. The settlement agreement resolved complicated
3 disputed claims. The agreement in principle was duly executed between both parties on
4 November 24, 1998. The final settlement agreement, signed on January 14, 1999 included
5 a payment schedule that has been incorporated into adjustment (PF6).
6 Q. What is the duration of this agreement and the levelized annual payments to
7 be made?
8 A. The duration of the final settlement agreement will be for a term of 45 years
9 and involves levelized payments of $873,000 per year on a system basis, or $584,000 for
10 the Washington jurisdiction.
11 Q. What was the impact of this adjustment on Washington jurisdictional
12 operations?
13 A. The effect of this adjustment is to decrease Washington net operating income
14 by $380,000.
15 Q. What damages did the Tribe originally seek to recover.
16 A. The Tribe alleged losses ranging from $425 million to $650 million, together
17 with $100 million in punitive damages.
18 Q Are the actual cash payments to be made up of equal installments?
19 A. No. The initial payment for 1999 is $2,500,000, with all subsequent
20 payments to be in the amount of $835,498. (These amounts are on a system electric basis.)
21 Q. How is the Company proposing that these payments be handled for
22 ratemaking?
23 A. The Company is proposing that the total payments scheduled to occur over
24

1 the 45 year duration of the agreement be levelized on a system basis and allocated based
2 upon the Production/Transmission formula.

3 Q. How does this agreement meet Commission requirements for known and
4 measurable changes?

5 A. As noted previously, an agreement in principle was signed on November 24,
6 1998. It was the culmination of a legal proceeding that was initiated in 1991 and the result
7 of litigation, extensive negotiation and subsequent mediation. The final agreement was then
8 approved by a vote of the Tribe, signed January 14, 1999 and payments from the Company
9 began in 1999.

10 Q. How does the Company propose to handle the accounting treatment for the
11 settlement costs?

12 A. The Company proposes that the annual cash payments be recorded in FERC
13 account 165, Prepayments, and that annual levelized amortization be recorded in FERC
14 account 557, Other Power Supply Expenses.

15 Q. Please turn to the final page of Exhibit No. 28, page 9, and continue with
16 your explanation of the adjustments.

17 A. Column (PF7), Pro Forma Labor/Benefit Adjustment, reflects known and
18 measurable changes to salary levels as well as normalization of test period benefit costs.
19 The Labor calculation consists of two components. This adjustment is sponsored by
20 Witness Mitchell and her testimony explains its derivation in detail. The combined effect
21 of this adjustment results in a reduction to Washington net operating income of $386,000.

22 Column (PF8), Pro Forma Revenue Adjustment, is a 3-fold adjustment taking into
23 account known and measurable changes that include revenue normalization, weather
24

normalization and an unbilled revenue calculation. It encompasses rate schedule shifts, repricing for approved tariff changes that will be in place in the pro forma test period that were not in place in the historical test period. Also, it includes an increase in electric revenues due to the process of normalizing weather sensitive electric kWh sales, which in this case, eliminates the effect of warmer than historical normal temperatures. Witness Hirschkorn is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $1,555,000.

Column (PF9), Pro Forma Miscellaneous Adjustments, takes certain period costs incurred in 1998 and spreads the amounts over a 5-year period to better reflect the costs longer-term nature. The effect of this adjustment is to increase Washington net operating income by $679,000.

Q. Please explain the period costs that are included in the Pro Forma Miscellaneous Adjustment?

A. The period costs were expenditures that the Company made for computer and software modifications aimed at allowing computers to properly handle calendar dates that included the year 2000, commonly called Y2K costs, and costs associated with changing the Company's name.

Q. Why are you asking for amortization of Y2K costs that were expensed as period costs in 1998?

A. Despite being required to expense Y2K costs for financial reporting purposes, it is the Company's contention that these are legitimate business expenditures that will continue to produce benefits beyond the period the costs were incurred; in this case 1998. Only incremental expenditures specific to Y2K upgrades or modifications are

1 included in this adjustment. Expenditures that qualified as capital were capitalized.
2 Ongoing computer maintenance expenditures remained as period costs. Also, no deferrals
3 from 1997, nor pro forma amounts from 1999 are included in the amount being amortized.
4 It is generally accepted that without the software modifications, the majority of the
5 Company's mainframe software applications would not be functional in the year 2000 and
6 forward. The financial accounting community, and in turn the Securities and Exchange
7 Commission, based their requirement to expense Y2K costs on their desire for uniformity in
8 financial reporting and a narrow interpretation of an existing accounting standard (FAS-86-
9 Accounting for the Costs of Computer Software...) that defined maintenance as an activity
10 undertaken to correct errors or to update a product for current information. The argument
11 that Y2K modifications are enhancements or improvements that produce future benefits is
12 just as valid. The new value the Y2K projects will create is that the systems will continue
13 to perform properly, instead of failing. If one suggests that this is not of new value, then
14 they would be arguing that the continued proper functioning of these systems has no value.
15 The Company submits that continued proper functionality has long-term value.
16 Q. Why isn't the Company requesting to pro form in expenditures incurred
17 subsequent to 1998?
18 A. By requesting only the expenditures that incurred in 1998, the Company is
19 effectively sharing the costs of the required modifications between shareholders and
20 customers. Besides expenditures incurred in 1999, the Company also incurred some
21 preliminary expenditures in 1997.
22 Q. Why are you proposing to amortize the Y2K costs over 5 years?
23 A. 5 years is the standard time period that the Company amortizes software
24

1 development costs.

2 Q. Please explain the adjustment as it relates to name change costs.

3 A. In 1998, to create a cohesive identity across diverse businesses, the
4 Company embarked on a process of changing its name to Avista Corp. for not only the
5 parent company, but also transitioned to Avista-based names for all non-regulated business
6 units. It should be noted that the Company preserved its regional utility names where it was
7 found to be beneficial, such as the Washington Water Power Division being used in
8 Washington and Idaho.

9 Q. Why did the Company change its name?

10 A. It was decided that a disciplined approach to building a cohesive identity
11 would leverage name recognition across markets, helping build market acceptance more
12 readily and more effectively per dollar invested. Washington Water Power was a very
13 strong name in select markets, but lacked versatility. In contrast, the Avista name is not
14 specific as to resource or geography and has been successfully launched and favorably
15 received in many new markets.

16 Q. What are the benefits to changing the Company's name?

17 A. The change allows the Company to quickly and cost-effectively create a
18 presence as a diversified energy company linked to a singular, simple and flexible identity.
19 The Avista brand also establishes a rational relationship and identity among our businesses
20 and created a stronger financial identity. It also eliminates the periodic confusion that
21 people and institutions have with the similarity between Washington Water Power and the
22 Washington Public Power Supply System, referred to phonetically as "WHOOPS," that
23 became infamous for defaulting on billions of dollars of tax-exempt bonds issued for
24

construction of several nuclear plants back in the 1970's and 1980's.

Q. Why are you utilizing 5 years for amortization of the name change costs?

A. It was simply a reasonable period over which it could be assumed that the Company's name change would have been implemented and completely accepted by customers and external markets.

Q. Please continue with your explanations of the adjustments on page 9 of your Exhibit No. 28.

A. Column (PF10), Pro Forma MOPS Adjustment, reflects an increase in amortization costs and rate base associated with recovery of incremental program costs and portions of the lost margin associated with the Company's experimental deregulation programs, MOPS I and MOPS II. The MOPS I accounting treatment was approved as part of Docket UE-970209. The MOPS II accounting treatment was approved as part of Docket UE-971668. Both dockets included a requirement that recovery of the costs be addressed in the Company's next electric general rate increase filing. This adjustment decreases state of Washington net operating income by $92,000 and increases rate base by $351,000.

The final column, Column (PF11), Pro forma Total, reflects total 1998 pro forma results of operations and rate base consisting of 1998 actual results and the total of all adjustments.

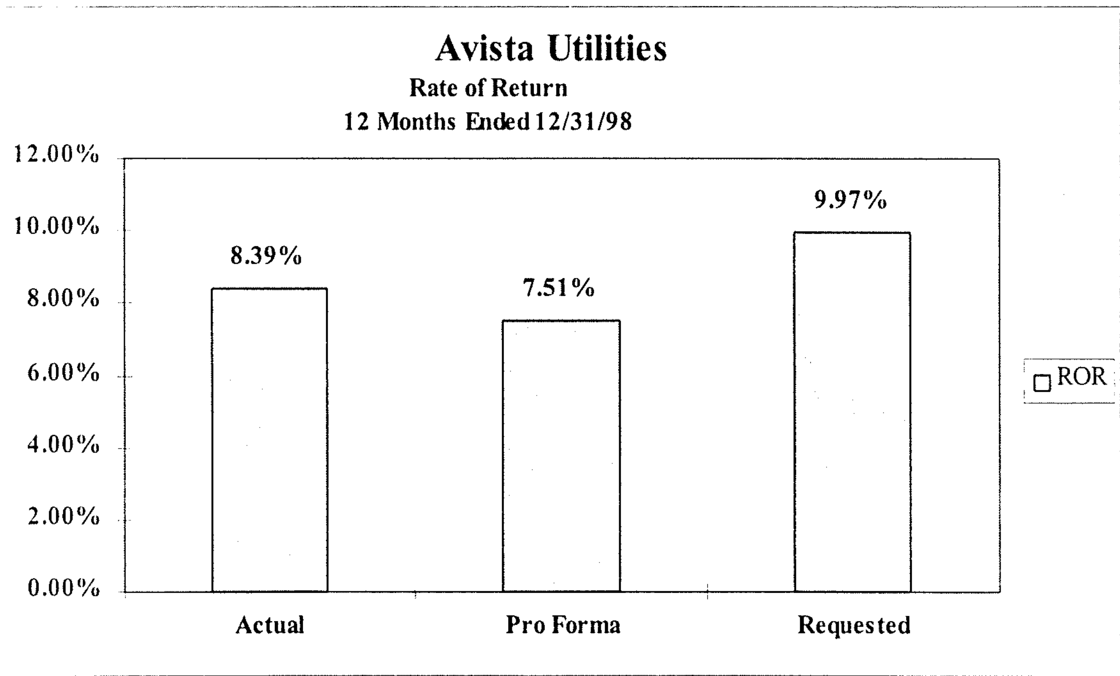
Q. Referring back to page 1, line 42, of Exhibit No. 28, for identification, what were the actual and pro forma electric rates of return realized by the Company during the test period?

A. For the state of Washington, the actual test period rate of return was 8.39%, which is below the last authorized rate of return of 10.67%. The test period pro forma rate

of return is 7.51% under present rates. Thus, the Company does not, on a pro forma basis for the test period, realize the composite 9.97% rate of return requested by the Company in this case.

Q. By way of summary, could you please review the different rates of return that you have presented in your testimony?

A. Yes. Basically, there are three different rates of return discussed previously. The actual ROR earned by the Company during the test period, the Pro Forma ROR determined in my Exhibit No. 28 and the requested ROR. For convenience of comparison, please refer to the following graph:



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 composite rate of 9.97% rate of return on a pro forma basis?

1 A. The net operating income deficiency amounts to $16,301,000, as shown on
2 line 9 of page 2 of Exhibit No. 28. The resulting revenue requirement is shown on line 11
3 and amounts to $26,253,000, or an increase of 10.43% over pro forma general business
4 revenues.
5
6 **NATURAL GAS SECTION**
7 **UG-99____**
8 Q. Would you now please begin your testimony as it specifically relates to the
9 natural gas portion of the Company's general rate filing.
10 A. Certainly. As in the preceding electric portion, I will be presenting the
11 Company's overall revenue requirement and my testimony and exhibits in this proceeding
12 will generally cover accounting and financial data in support of the Company's need for the
13 proposed increase in rates. I will explain pro formed operating results including expense
14 and rate base adjustments made to actual operating results and rate base. The pro forma net
15 operating income and rate base that serve as the basis for the overall revenue requirement in
16 this filing incorporate not only those adjustments prepared by myself, but also by Company
17 Witnesses Hirschkorn, Mitchell and DeFelice. I will cover each of those adjustments
18 briefly while their testimonies will provide more in-depth discussions. My testimony will
19 also cover the system and jurisdictional allocations used in preparation of the Company's
20 pro forma results of operations study presented in this proceeding.
21 Q. Are you sponsoring any exhibits that are specific to the natural gas section of
22 the Company's filing?
23 A. Yes. Exhibit No(s). 30 and 31, as previously marked for identification,
24

which were prepared under my supervision and direction.

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

A. The test period being used by the Company is the twelve month period ending December 31, 1998 presented on a pro forma basis.

Q. What is the rate of return that the Company's was last authorized by this Commission for its gas operations in Washington?

A. The Company's currently authorized rate of return for its Washington gas operations is 10.67%. That rate dates back to Docket No. 88-2380 which became effective in November of 1989, and was later stipulated to in Docket No. UG-900190, which became effective in August of 1990.

Q. Has the Company come before this Commission with a general gas filing since the UG-900190 docket.

A. Yes. The Company filed a request for a general gas increase with this Commission on June 27, 1997 under Docket No. UG-971071. That case resulted in a settlement agreement between all parties that was ultimately approved by this Commission.

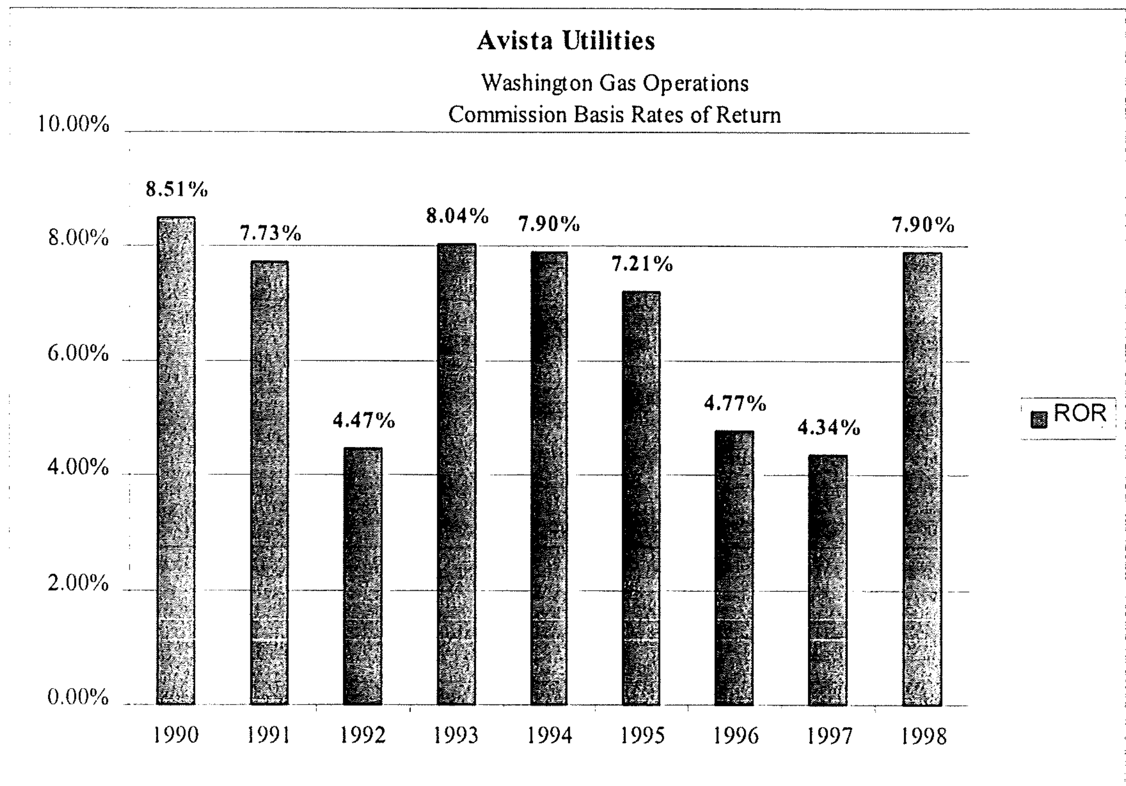
Q. Did the settlement result in a newly authorized rate of return of the Company's Washington gas operations.

A. No. The parties agreed, for purposes of the settlement only, to a stated return on equity and an associated rate of return. However, Section 4.3 of the settlement, entitled "No Precedent," stated the following:

> "By executing this Settlement, no undersigned Party shall be deemed to have accepted or consented to the facts, principles, methods or theories employed in arriving at the Settlement, nor shall any

1 undersigned Party be deemed to have agreed that such a Settlement is
2 appropriate for resolving revenue requirement, rate design, rate spread,
3 cost of service, or other issues in any other proceeding, nor shall any
4 Party refer to the Settlement for such purposes.
5 Q. Were there any other sections of the settlement agreement in UG-971071
6 that come to bear on this current request for an increase in natural gas prices in the
7 Company's Washington jurisdiction?
8 A. Yes. Section 1.3, entitled "Commitment to Rate Freeze," states:
9 "The undersigned Parties agree that the Company will not seek
10 general rate relief for its Washington natural gas operations to become
11 effective prior to January 1, 2000, resulting in approximately a two
12 year freeze in general revenue requirements.
13 Q. What has been the Company's experienced earnings levels since the rate
14 change associated with Docket No. UG-900190 and through the end of 1998.
15 A. The Company has consistently earned well below its authorized level of
16 10.67%. As I mentioned earlier, one of my main responsibilities is preparation of the semi-
17 annual gas report as required in Washington pursuant to WAC 480-90-031. These reports
18 are prepared on a "Commission Basis." Commission Basis means that rate base includes
19 standard rate base components that have historically been accepted by the Commission for
20 ratemaking. Additionally, the Company's booked results of operations are adjusted to a
21 ratemaking basis by eliminating out-of-period items, nonrecurring items or any other item
22 that would materially distort the test period's results. The final result is a restated rate of
23 return for the reporting period. A historical review below, of the Company's filings with
24

1 the Commission, show that the Company's gas operations earned less than its allowed rate
2 of return for a number of years, including 1998, which included a full year of the general
3 increase associated with UG-971071.



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Q. What is one of the factors contributing to the Company's inability to earn its
15 authorized rate of return?
16
17 A. One of the contributing factors to the Company experiencing lower than
18 authorized returns has been the increase in embedded rate base per customer brought about
19 by the large increase in gas customers the Company has experienced since 1990. Per
20 customer margins, margins being gross revenues less gas costs, have remained at relatively
21 static levels, as would be expected outside a general increase in rates, while embedded rate
22 base per customer has been increasing. This combination of higher rate base and static
23 margins automatically produce lower returns. The rate increase implemented January 1,
24 1998 has improved the situation, however, the Company's earnings levels, even after a full

12 months of the increase, are still below reasonable levels.

Q. You mentioned the Company has experienced a large increase in gas customers since 1990, which was when the Company started supplying the Commission with Semi-Annual Reports. How much has your average number of customers grown since that time?

A. The Company's average gas customers in Washington increased from 68,846 to 114,098, or 66%, since 1990. Average customers have increased by 9% just since the 1996 test year that was utilized in the Company's last general rate increase mentioned earlier.

ALLOCATION PROCEDURES

Q. Referring to what has been marked as Exhibit No. 31, would you explain what is included in this exhibit?

A. Yes. Exhibit No. 31 is an explanation of the allocation procedures used for revenues, expenses and rate base. For ratemaking purposes, the Company must allocate revenues, expenses and rate base between electric and gas services and between Washington, Idaho, Oregon and California jurisdictions where gas service is provided.

Q. Have allocation procedures changed since the Company' last fully litigated gas case.?

A. Yes. Since the Company' last fully litigated gas case., the Company acquired natural gas operating properties in Oregon and California. New procedures for allocating common costs and common general plant were developed in conjunction with the

1 Staffs of all four state jurisdictions. The Commission Staff performed a preliminary
2 analysis of the Company's new methodology for assigning and allocating common costs
3 between services and jurisdictions and found them to be reasonable. The Staff did reserve
4 the right to audit and fully scrutinize the methodology in the Company's first general case.
5 The new methodology was implemented at the start of 1994.
6 Q. What information does Exhibit No. 31 provide?
7 A. Exhibit No. 31 provides a narrative description of the main components of
8 the current procedures utilized in allocating revenue, expense and rate base between
9 services and between jurisdictions within the gas service.
10
11 **REVENUE REQUIREMENT**
12
13 Q. Now, handing you what has been marked as Exhibit No. 30, for
14 identification, would you please outline what is shown in this exhibit?
15 A. Yes. Exhibit No. 30 shows actual and pro forma gas operating results and
16 rate base for the test period for the state of Washington. Column (b) of page 1 of Exhibit
17 No. 30 shows 1998 operating results and components of the average-of-monthly-average
18 rate base as recorded; column (c) is the total of all adjustments to net operating income and
19 rate base; and column (d) is pro forma results of operations, all under existing rates.
20 Column (e) shows the revenue increase required which would allow the Company to earn a
21 9.93% rate of return. Column (f) reflects pro forma gas operating results with the requested
22 increase of $4,899,000.
23 Q. Would you please explain page 2 of Exhibit No. 30?
24

1 A. Yes. Page 2 shows the calculation of the $4,899,000 revenue requirement at
2 the requested 9.93% rate of return.
3 Q. Would you now please explain page 3 of Exhibit No. 30?
4 A. Yes. Page 3 shows the derivation of the net to gross revenue conversion
5 factor. The conversion factor takes into account uncollectible accounts receivables,
6 Commission fees, Washington State Excise Taxes and Franchise Fees. Federal income
7 taxes are reflected at 35%.
8 Q. Now turning to pages 4 through 8 of your Exhibit No. 30, for identification,
9 would you please explain what those pages show?
10 A. Yes. Page 4 begins with actual operating results and rate base for the test
11 period in column (b). Individual normalizing adjustments that standard components of our
12 semi-annual reporting to the Commission begin in column (c) on page 4 and continue
13 through column (s) on page 7. Column (t) on page 7, entitled Restated Total, is the subtotal
14 of all preceding columns. Individual pro forma and additional normalizing adjustments
15 begin in column (PF1) on page 8 and continue through column (PF4) on page 8. Column
16 (PF5) is the pro forma operating results and rate base for the test period.
17
18 **COMMISSION BASIS ADJUSTMENTS**
19
20 Q. Would you please explain each of these adjustments, the reason for the
21 adjustment and its effect on test period state of Washington net operating income and/or
22 rate base?
23 A. Yes. The first adjustment, column (c) on page 4, entitled Deferred FIT Rate
24

1 Base, reflects the rate base reduction for Washington's portion of deferred taxes. The
2 adjustment reflects the deferred tax balances arising from accelerated tax depreciation
3 (Accelerated Cost Recovery System, ACRS, and Modified Accelerated Cost Recovery,
4 MACRS), bond refinancing premiums, and contributions in aid of construction. The effect
5 on state of Washington rate base is a reduction of $10,295,000.

6 Column (d), Deferred Gain on Office Building, reflects the rate base reduction for
7 Washington's portion of the net of tax, unamortized gain on the sale of the Company's
8 general office facility. The facility was sold in December 1986 and leased back by the
9 Company. The treatment of the gain on the sale follows the Commission's Order Granting
10 Application in Cause No. FR-86-150. The effect on state of Washington rate base is a
11 reduction of $400,000.

12 Column (e), Gas Inventory, reflects the adjustment to rate base for the average of
13 monthly average value of gas stored at the Company's Jackson Prairie underground storage
14 facility and the Plymouth LNG Plant. This adjustment is consistent with the Third
15 Supplemental Order in Docket No. U-88-2380-T. The effect on state of Washington rate
16 base is an increase of $1,458,000.

17 Column (f), Weatherization and DSM Investment, includes in rate base the balances
18 (net of amortization) of natural gas demand side management (DSM) program consistent
19 with agreements with Commission Staff in Docket No. UG-941376 and UG-941378. As I
20 mentioned earlier, witness Folsom is sponsoring additional testimony regarding the
21 Company's expenditures for energy efficiency programs.The effect of this adjustment is to
22 increase rate base by $4,443,000.

23 Q. Please turn to page 5 and explain the adjustments shown there.

24

1 A. The adjustment in column (g), Customer Advances, decreases rate base for
2 funds advanced by customers for line extensions as they will most likely be recorded as
3 contributions in aid of construction at some future time. The effect on state of Washington
4 rate base is a decrease of $99,000.
5 The column marked by a dash, and immediately following column (g), subtotals
6 columns (b) through (g) and represents actual operating results and rate base plus the
7 standard rate base adjustments that are included in Commission Basis reporting, but not
8 generally calculated in the Company's monthly Results of Operations reports.
9 Column (h), Eliminate B & O Taxes, eliminates the revenues and expenses
10 associated with local business and occupation taxes which the Company is allowed to pass
11 through to customers. The adjustment eliminates any timing mismatch that exists between
12 the revenues and expenses by eliminating the revenues and expenses in their entirety. B&
13 O Taxes are passed through on a separate schedule which is not part of this proceeding.
14 This restating adjustment is consistent with the Third Supplemental Order in Docket No. U-
15 88-2380-T. The effect of this adjustment is to increase state of Washington net operating
16 income by $112,000.
17 Column (i), Pro Forma Property Tax, restates the 1998 test period accrued levels of
18 property taxes to the actual amounts. This restating adjustment is consistent with the
19 column (y) adjustment included in the stipulation in Docket No. UE-900093. The effect of
20 this particular adjustment is to increase Washington net operating income by $14,000.
21 Column (j), Uncollectible Expense, restates the accrued expense to the actual level
22 of net write-offs for the test period. This restating adjustment is consistent with the Third
23 Supplemental Order in Docket No. U-88-2380-T. The effect of this adjustment is to
24

1 increase Washington net operating income by $147,000.

2 Column (k), Regulatory Expense Adjustment, restates booked 1998 regulatory
3 expense to reflect the WUTC assessment rates applied to revenues for the test period. This
4 restating adjustment is consistent with the Third Supplemental Order in Docket No. U-88-
5 2380-T. The effect of this adjustment is to decrease Washington net operating income by
6 $10,000.

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

8 A. Column (l), Injuries and Damages, is a restating adjustment that replaces the
9 accrual with actuals to get the six year rolling average of injuries and damages payments not
10 covered by insurance. As a result of the Commission's Order in Docket No. U-88-2380-T,
11 the Company changed to the reserve method of accounting for injuries and damages not
12 covered by insurance. This adjustment is consistent with the Third Supplemental Order in
13 Docket U-88-2380-T. The effect of this adjustment is to decrease Washington net operating
14 income by $29,000.

15 Column (m), entitled FIT, is required to reflect the appropriate level of federal
16 income tax expense for the test period. This adjustment removes the effect of certain
17 Schedule M items, matches the jurisdictional allocation of other Schedule M items to
18 related Results of Operations allocations, eliminates any prior period income tax expense,
19 and amortizes audit adjustment payments over a two year period. The normal audit cycle is
20 an audit every two years covering two years of returns. This adjustment also reflects the
21 proper level of deferred tax expense for the test period. The effect of this adjustment, all
22 based upon a Federal tax rate of 35%, is to decrease Washington net operating income by
23 $422,000.

24

1 Column (n), Pro Forma Restate Debt Interest, restates debt interest using the
2 Company's pro forma weighted average cost of debt, as outlined in the testimony and
3 exhibits of Witness Avera and applied to Washington's pro forma level rate base, plus
4 construction work in progress, to produce a pro forma level of tax deductible interest
5 expense. The effect of this particular adjustment is to decrease Washington net operating
6 income by $289,000.

7 Column (o), Eliminate A/R Expenses, A/R representing Accounts Receivable,
8 removes expenses associated with the sale of customer accounts receivable. This restating
9 adjustment is consistent with the Commission's Third Supplemental Order in Docket No.
10 U-88-2380-T. The effect of this adjustment is to increase Washington net operating income
11 by $159,000.

12 Column (p), Office Space Charged to Subs, removes a portion of the office space
13 costs (building lease and O&M costs, common area costs, copier expense and annual office
14 furniture rental) using the percentage of labor dollars charged to subsidiary activities by
15 employee compared to total labor dollars by employee. These percentages are applied to
16 the employees' office space (expressed in square feet) and multiplied by office space
17 costs/per square foot. This restating adjustment is made as a result of the Commission's
18 Third Supplemental Order in Docket No. U-88-2380-T which required the company to
19 perform a space utilization study to allocate costs to subsidiaries. Due to the Company's
20 efforts at segregating subsidiary activities, this adjustment has historically been a relatively
21 small adjustment. The effect of this adjustment is to increase Washington net operating
22 income by $4,000.

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

24

1 A. Column (q), Restate Excise/Franchise Taxes, removes the effect of a one
2 month lag between the book and the actual level of taxes paid. This restating adjustment is
3 consistent with the Third Supplemental Order in Docket No. U-88-2380-T. The effect of
4 this adjustment is to reduce Washington net operating income by $459,000.
5 Column (r), Lease Expense Adjustment, restates the straight-line accrual of lease
6 payments for the Company's general office building to a cash basis. This restating
7 adjustment is consistent with the Third Supplemental Order in Docket No. U-88-2380-T.
8 The effect of this adjustment is to increase Washington net operating income by $13,000.
9 Column (s), entitled Restated Total, subtotals all the preceding columns (b) through
10 column (r), exclusive of the previously discussed subtotal column. These totals represent
11 actual operating results and rate base plus the majority of the standard normalizing
12 adjustments that the Company includes in its semi-annual Commission Basis reports. The
13 one notable exception to the list of standard Commission Basis adjustments, up to this
14 point, is pro forma adjustment (PF3), the Pro Forma Revenue adjustment. That adjustment,
15 which will be discussed later by myself and Witness Hirschkorn, has been produced in
16 more detail than was originally prepared for the Commission Basis reports.
17
18 **PRO FORMA AND ADDITIONAL NORMALIZING ADJUSTMENTS**
19
20 Q. Please turn to page 8 explain the significance of the 4 columns subsequent to
21 column (s) in your Exhibit No. 30.
22 A. All adjustments subsequent to column (s) are signified by a PF with an
23 identifying digit, 1 through 4. These adjustments bring the operating results and rate base
24

1 to the Company's final pro forma level for the test year. It should be noted that the sum of
2 the pro forma adjustments serve to increase the pro forma net operating income which in
3 turn reduce the ultimate revenue requirement requested by the Company.

4 Q. Please continue with your explanation of the adjustments on page 8.

5 A. Column (PF1), Pro Forma Depreciation Adjustment, reflects an increase in
6 depreciation expense due to the utilization of new depreciation rates that were the result of a
7 detailed depreciation study performed by a consultant from Deloitte & Touche, LLP. This
8 adjustment also eliminates the out-of-period annual depreciation expense true-up
9 adjustment for 1997 and adds in the true-up for 1998 that was recorded in 1999. The
10 Company last changed its depreciation rates on January 1, 1990. Witness DeFelice is
11 sponsoring this adjustment and will explain it in more detail. The effect of this adjustment
12 is to decrease Washington net operating income by $359,000 and to decrease Washington
13 rate base by $179,000.

14 Column (PF2), Pro Forma Labor/Benefit Adjustment, reflects known and
15 measurable changes to salary levels as well as normalization of test period benefit costs.
16 The Labor calculation consists of two components. This adjustment is sponsored by
17 Witness Mitchell and her testimony explains its derivation in detail. The combined effect
18 of this adjustment results in a reduction to Washington net operating income of $108,000.

19 Column (PF3), Pro Forma Revenue Adjustment, is a 3-fold adjustment taking into
20 account known and measurable changes that include revenue normalization, weather
21 normalization and an unbilled revenue calculation. Also, sales for resale revenues and
22 associated gas costs that are captured in the Company's annual purchased gas adjustment
23 filings are eliminated. It encompasses rate schedule shifts, repricing for approved tariff
24

changes that will be in place in the pro forma test period that were not in place in the historical test period. Also, it includes an increase in revenues due to the process of normalizing weather sensitive therm sales, which in this case, eliminates the effect of warmer than historical normal temperatures. The revenue adjustment for weather sensitive therm sales has an associated impact on purchased gas costs. Witness Hirschkorn is sponsoring this adjustment. The effect of this particular adjustment is to increase Washington net operating income by $1,516,000.

Column (PF4), Pro Forma Miscellaneous Adjustments, takes certain period costs incurred in 1998 and spreads the amounts over a 5-year period to better reflect the costs longer-term nature. The effect of this adjustment is to increase Washington net operating income by $172,000.

Q. Please explain the period costs that are included in the Pro Forma Miscellaneous Adjustment?

A. The period costs were expenditures that the Company made for computer and software modifications aimed at allowing computers to properly handle calendar dates that included the year 2000, commonly called Y2K costs, and costs associated with changing the Company's name.

Q. Why are you asking for amortization of Y2K costs that were expensed as period costs in 1998?

A. Despite being required to expense Y2K costs for financial reporting purposes, it is the Company's contention that these are legitimate business expenditures that will continue to produce benefits beyond the period the costs were incurred; in this case 1998. Only incremental expenditures specific to Y2K upgrades or modifications are

1 included in this adjustment. Expenditures that qualified as capital were capitalized.
2 Ongoing computer maintenance expenditures remained as period costs. Also, no deferrals
3 from 1997, nor pro forma amounts from 1999 are included in the amount being amortized.
4 It is generally accepted that without the software modifications, the majority of the
5 Company's mainframe software applications would not be functional in the year 2000 and
6 forward. The financial accounting community, and in turn the Securities and Exchange
7 Commission, based their requirement to expense Y2K costs on their desire for uniformity in
8 financial reporting and a narrow interpretation of an existing accounting standard (FAS-86-
9 Accounting for the Costs of Computer Software...) that defined maintenance as an activity
10 undertaken to correct errors or to update a product for current information. The argument
11 that Y2K modifications are enhancements or improvements that produce future benefits is
12 just as valid. The new value the Y2K projects will create is that the systems will continue
13 to perform properly, instead of failing. If one suggests that this is not of new value, then
14 they would be arguing that the continued proper functioning of these systems has no value.
15 The Company submits that continued proper functionality has long-term value.
16 Q. Why isn't the Company requesting to pro form in expenditures incurred
17 subsequent to 1998?
18 A. By requesting only the expenditures that incurred in 1998, the Company is
19 effectively sharing the costs of the required modifications between shareholders and
20 customers. Besides expenditures incurred in 1999, the Company also incurred some
21 preliminary expenditures in 1997.
22 Q. Why are you proposing to amortize the Y2K costs over 5 years?
23 A. 5 years is the standard time period that the Company amortizes software
24

1 development costs.

2 Q. Please explain the adjustment as it relates to name change costs.

3 A. In 1998, to create a cohesive identity across diverse businesses, the

4 Company embarked on a process of changing its name to Avista Corp. for not only the

5 parent company, but also transitioned to Avista-based names for all non-regulated business

6 units. It should be noted that the Company preserved its regional utility names where it was

7 found to be beneficial, such as the Washington Water Power Division being used in

8 Washington and Idaho.

9 Q. Why did the Company change its name?

10 A. It was decided that a disciplined approach to building a cohesive identity

11 would leverage name recognition across markets, helping build market acceptance more

12 readily and more effectively per dollar invested. Washington Water Power was a very

13 strong name in select markets, but lacked versatility. In contrast, the Avista name is not

14 specific as to resource or geography and has been successfully launched and favorably

15 received in many new markets.

16 Q. What are the benefits to changing the Company's name?

17 A. The change allows the Company to quickly and cost-effectively create a

18 presence as a diversified energy company linked to a singular, simple and flexible identity.

19 The Avista brand also establishes a rational relationship and identity among our businesses

20 and created a stronger financial identity. It also eliminates the periodic confusion that

21 people and institutions have with the similarity between Washington Water Power and the

22 Washington Public Power Supply System, referred to phonetically as "WHOOPS," that

23 became infamous for defaulting on billions of dollars of tax-exempt bonds issued for

24

1 construction of several nuclear plants back in the 1970's and 1980's.

2 Q. Why are you utilizing 5 years for amortization of the name change costs?

3 A. It was simply a reasonable period over which it could be assumed that the

4 Company's name change would have been implemented and completely accepted by

5 customers and external markets.

6 Column (PF5), Pro forma Total, reflects total 1998 pro forma results of operations

7 and rate base consisting of 1998 actual results and the total of all adjustments.

8 Q. Referring back to page 1, line 43, of Exhibit No. 30, for identification, what

9 was the actual and pro forma gas rate of return realized by the Company during the test

10 period?

11 A. For the state of Washington, the actual test period rate of return was 6.76%.

12 The test period pro forma rate of return is 7.42% under present rates. Thus, the Company

13 does not, on a pro forma basis for the test period, realize the 9.93% rate of return requested

14 by the Company in this case.

15 Q. By way of summary, could you please review the different rates of return

16 that you have presented in your testimony?

17 A. Yes. Basically, there are four different rates of return ("ROR") discussed

18 previously. The actual ROR earned by the Company during the test period, the

19 Commission Basis ROR filed with this Commission, the Pro Forma ROR determined in my

20 Exhibit No. 30 and the requested ROR. For convenience of comparison, please refer to the

21 following graph:

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23

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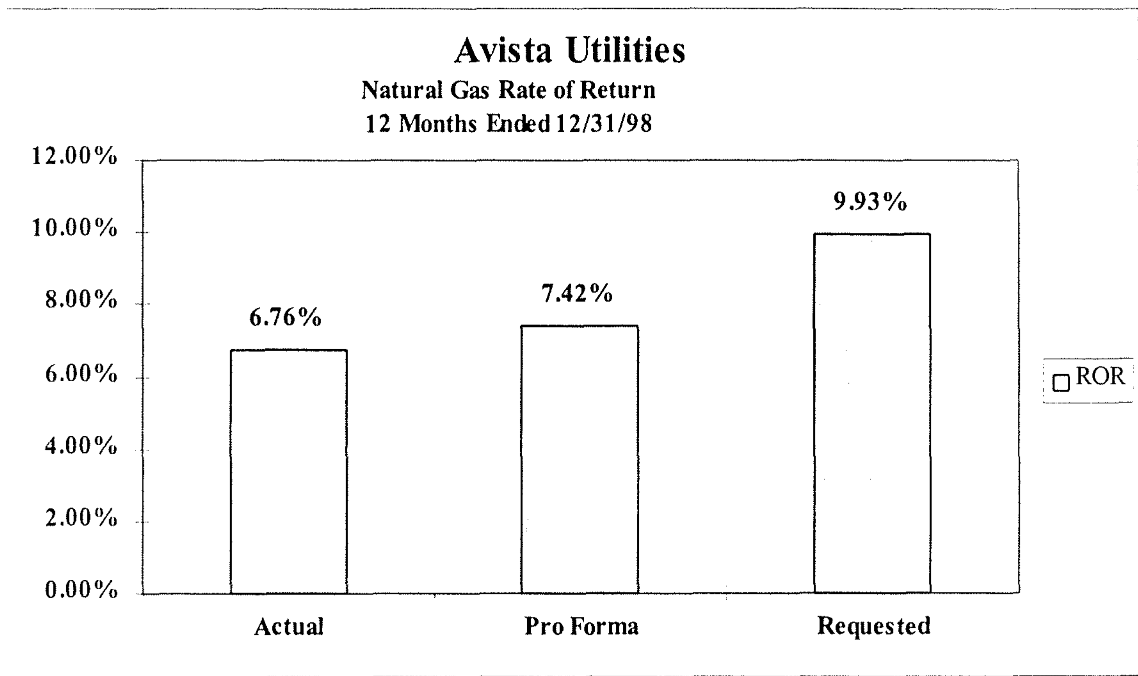

Q. How much additional net operating income would be required for the state of Washington gas operations to allow the Company an opportunity to earn its proposed 9.93% rate of return on a pro forma basis?

A. The net operating income deficiency amounts to $3,020,000, as shown on line 5 of page 2 of Exhibit No. 30. The resulting revenue requirement is shown on line 7 and amounts to $4,899,000, or an increase of 6.53% over pro forma general business and transportation revenues.

Q. Does that conclude your direct testimony?

A. Yes, it does.