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BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

DOCKET NO. UE-010395

REBUTTAL TESTIMONY OF DON M. FALKNER
REPRESENTING THE AVISTA CORPORATION

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INTRODUCTION

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

3 A. My name is Don M. Falkner. My business address is East 1411 Mission Avenue,
4 Spokane, Washington. I am employed by Avista Corp. (Company) as a Senior Rate Accountant.

5 Q. Have you previously provided direct testimony in this Case?

6 A. Yes. The main points my testimony covered were the overall revenue requirement
7 calculation and utilization of "PGE" credits to mitigate the surcharge increase.

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

9 A. My rebuttal testimony will address Staff's accounting testimony regarding the
10 recording of the power cost deferral entries and their proposal for accounting for any increase in
11 revenues.

SUMMARY

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13 Q. Could you please summarize the Company's position with regard to the
14 accounting testimony of the Commission Staff?

15 A. The Commission Staff's testimony addressing how Avista accounted for the
16 power cost deferrals authorized by the Commission should not be an issue in this surcharge case
17 because the Company was implementing an approved account order with guidance from its
18 independent auditors. It is also consistent with Staff's memo. Also, the Commission Staff
19 recommendation to segregate liability on the Company's balance sheet for revenues subject to
20 refund does not materially address the Company's current financial situation, it complicates the
21 accounting for the deferral mechanism and provides no basis for the Company to even record the
22 increased revenues from customers.

1 Q. Has the Company complied with the recommendations of the Commission and
2 Staff in regards to applying for an accounting order and how to implement this particular
3 accounting order?

4 A. Yes.

5 **FINANCIAL ACCOUNTING FOR THE DEFERRAL MECHANISM ENTRIES**

6 Q. Who makes the determinations regarding how the Company's financial statements
7 reflect GAAP?

8 A. Initially, the Company makes the original entries, but the ultimate decision requires
9 concurrence of the Company's independent auditors.

10 Q. Was this done?

11 A. Yes. The deferral mechanism and its associated accounting was initiated effective
12 July 1, 2000. The Company's 2000 annual report to the SEC, generally known as the 10-K, was
13 reviewed by the Company's independent auditors, the international firm of Deloitte & Touche,
14 LLP. The testimony of Mr. Thomas Hoover, who is the lead partner from Deloitte & Touche on
15 the Avista audit engagement will explain their review in detail.

16 Q. What did their opinion state?

17 A. In summary, their opinion stated that they had performed an audit of the
18 Company's financial statements and related disclosures according to accepted auditing standards.
19 They then state that,

20 "In their opinion, the consolidated financial statements present fairly, in all
21 material respects, the financial position of the Company at December 31, 2000
22 and 1999, as the results of operations and its cash flows for each of the three
23 years in the period ended December 31, 2000, in conformity with accounting
24 principles generally accepted in the United States of America.

1 Q. Has Deloitte & Touche reviewed the Company's subsequent filings with the SEC?

2 A. Yes. They reviewed the Company's 1st and 2nd quarter 10-Q filings.

3 Q. Did the Company comply with Staff's memo and the Commission's order
4 regarding the inclusion of certain language in its financial statements filed with SEC essentially
5 disclosing the necessity of a prudence review prior to actual recovery of the power cost deferrals?

6 A. Yes. This was stated numerous times in both the Company's 10-K and 10-Qs.

7 Q. Was the history of the establishment of the Washington power cost deferrals
8 explained in the Company's 10-K?

9 A. Yes. It was outlined in three paragraphs in Note 1-Summary of Significant
10 Accounting Policies, under the heading of Power Cost Deferrals.

11 Q. In that note to the financials, did the Company imply that these deferrals were
12 subject to some adjustment mechanism that normally automatically passed through costs to
13 customers?

14 A. No. The Company's established PGA and Idaho PCA mechanisms were
15 described under a separate heading entitled Power and Natural Gas Cost Adjustment Provisions.

16 Q. Was the Staff aware that implementation of the deferral mechanism was going to
17 be recorded as an asset and impact current period earnings?

18 A. Yes. This was discussed in the Staff's memo dated January 24, 2001 under
19 Docket No. UE-000972 regarding the Company's proposal to modify the existing deferral
20 calculations. The memo, starting on the bottom of page 1 continuing onto page 2, outlines that as
21 the deferral mechanism operates,

22 "current period expenses are not recognized as current deductions to income,
23 thereby improving current earnings. When disposition of the deferred amounts

1 come, the escalated level of such deferred expenses exposes the company to a
2 greater potential of write-offs if full recovery of total amounts deferred is not
3 granted.” (Emphasis added)

4 The Staff recognized that costs would not affect earnings because the costs would be set
5 aside through the deferral mechanism. The only way that earnings would not be affected is if we
6 accounted for the deferrals the way we ultimately did, NOT the way Mr. Lott suggests in his
7 testimony. In addition, there cannot be a write-off unless an asset has been recorded first;
8 therefore Staff’s recognition that there could be a write-off, by implication, supports the
9 Company’s ultimate accounting treatment of the deferred costs.

10 Q. Why would the Staff require the Company to include a disclosure statement in its
11 financial statements if they didn’t expect the Company to record the power costs deferrals on its
12 balance sheet, pursuant to FAS-71 or any other financial standard?

13 A. It seems that it is implicit in that disclosure requirement that Staff expected the
14 deferrals to be recorded as we did; as a deferred charge on our balance sheet that would be
15 subject to some future Commission review.

16 Q. Do you have any other comments with regards to how the application of FAS-71
17 was portrayed by Staff?

18 A. Yes. Staff stated the following on page 10 of Mr. Lott’s testimony:

19 “...in order for Avista to book these deferrals in its published financial
20 statements, it would have to conclude that 100% of the deferred amounts would
21 probably be recovered by inclusion of the costs in a ratemaking procedure.”

22 Q. Do you agree with that assertion?

23 A. No. That is not true and clearly a misinterpretation of the conditions explained in
24 FAS-71. I have never read nor heard of any instance of 100% recovery being a condition for the

1 application of FAS-71 in the creation of an asset of any kind. If that was truly the case, then
2 virtually nothing could be recorded on the Company's financial books until after the Commission
3 had ruled on every last single dollar expended by the Company.

4 Q. How does FAS-71 define the term "probable"?

5 A. FAS-71 defines the term probable in footnote 6 to paragraph 9 of the Standard.

6 It reads as follows:

7 "The term *probable* is used in this Statement with its usual meaning, rather than
8 in a specific technical sense, and refers to that which can reasonably be expected
9 or believed on the basis of available evidence or logic, but is neither certain nor
proved (*Webster's New World Dictionary of the American Language*, 2d
college..."

10 Further, the first line of paragraph 9 of FAS-71, states that, "Rate actions of a regulator can
11 provide reasonable assurance of the existence of an asset." (Emphasis added) Nowhere in FAS-
12 71, or interpretations that I am aware of, is assurance of 100% recovery even implied.

13 Q. Did Staff provide a definition of "probable" in their testimony?

14 A. Yes. They did on page 10 of Mr. Lott's testimony. However, that definition is
15 either different, or at least an incomplete version of the definition included in FAS-71. The
16 definition provided by Staff and attributed to Webster's New Word Dictionary reads as follows:
17 "*probable*" as: "*likely to occur or be; that can be reasonably but not certainly expected.*"

18 Q. If the application of a portion, or portions of FAS-71 are left open to a certain
19 amount of professional judgement, who makes the final determination of how to apply FAS-71 to
20 the Company's financial statements?

21 A. As I stated earlier, financial statement presentations require concurrence by the
22 Company's independent accounting firm, Deloitte & Touche LLP, and they have made that

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1 determination as testified to by Mr. Hoover.

2 Q. Would it be reasonable to assume that the Company would not be allowed to
3 recover any of the extraordinary power costs it has incurred to serve its customers?

4 A. No.

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6 **REGULATORY ACCOUNTING**

7 Q. Did the Company record the power cost deferrals in the account recommended
8 by the Commission Staff?

9 A. Yes. We recorded them in FERC Account 186, Miscellaneous Deferred Debits.

10 Q. What is unique about using Account 186?

11 A. As the Staff memo included with Staff testimony as Exhibit___(MRL-3) notes on
12 the top of page 3, Account 186 is a catch-all account. We generally refer it to as a suspense
13 account. We use the term suspense because as the FERC definition notes, Account 186 can
14 contain, among other things, "...items the proper disposition of which is uncertain."

15 Q. Why did the Company propose using Account 186?

16 A. The Company proposed using that account because the power cost deferrals
17 were going to be the subject of future Commission review and had not received a Commission
18 order or action.

19 Q. Does the use of Account 186 somehow imply that the power cost deferrals are
20 regulatory assets that have a 100% probability of being recovered 100%.

21 A. No. It means that proper disposition has yet to be determined.

22 Q. Has the Company ever deferred any other expenditures in Account 186 that were
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1 going to be the subject of a future review by the Commission?

2 A. Yes. In the early 1990's, the Company deferred energy conservation
3 expenditures under an order and accompanying transmittal that noted they were subject to a future
4 review.

5 **COMPLIANCE WITH COMMISSION AND STAFF DIRECTION**

6 Q. You stated earlier that the Company has complied with all the recommendations
7 of the Commission and Staff in regards to applying for an accounting order and how to implement
8 this particular accounting order. How was the Company given direction in its decision to file for
9 an accounting order?

10 A. That direction came from testimony, transcripts and the final order in the
11 Company's most recent general case, UE-991606/UG-991607. The main topic at issue during
12 the discussions of the proper application of accounting orders was the Company's handling of the
13 extraordinary costs of dealing with a severe winter storm that has been called, "Ice Storm-1996."

14 Q. What direction was contained in the Commission's order in that docket?

15 A. The Commission's Third Supplemental Order in those dockets, in paragraph 206
16 states:

17 "Companies also have the opportunity to seek an accounting order from the
18 Commission if they want permission to amortize a cost for the purpose of
19 regulatory accounting, and an opportunity to seek recovery in a future rate case.

20 This practice gives notice to the Commission and parties who may wish to
21 examine, in a timely manner, the Company's earnings and other circumstances."

22 Q. What else did the Commission state in its Order?

23 A. Continuing into paragraph 207 of the Third Supplemental Order, it reads:

24 "Both the 1991 Firestorm and the 1996 Icestorm occurred before the test year.
Both are unusual events that appear to be "non-recurring," i.e., there is no

1 reason to expect that they will happen again in the rate year. **Avista did not**
2 **seek timely accounting orders for either event...**” (Emphasis added)

3 Q. Was there other information that came out of the Company’s general case that the
4 Company used in determining whether to file for an accounting petition to address the
5 extraordinary increase in power supply costs?

6 A. Certain questioning from Chairwoman Showalter to Staff witness Mr. Schooley
7 addressed when and why accounting petitions are used and some of the normal intent for those
8 petitions. The most illustrative portion begins on page 1545, line 20 of the official transcript goes
9 through page 1547, line 9, and it reads as follows:

10 “BY CHAIRWOMAN SHOWALTER:

11 Q. I don’t know if this all helps me or not. I comprehend the point of trying
12 to have only, you know, fairly regular ongoing expenses going into the basic
13 calculation. But then it seems that for extraordinary expenses, it’s the traditional
14 method to create an accounting petition of deferred accounting. But that too
15 goes into rate base. So it goes in whether it got filed in ’96 or ’97 or it gets
16 done today, doesn’t it?

17 A. It can, yes. If you put in an accounting petition, at least you
18 have given notice of it that it will occur and that you have had the chance to
19 judge whether that’s a reasonable thing to do.

20 Q. Yes, but don’t we have the same opportunity today? I’m not
21 saying it’s ideal, because we all would have been more familiar with this issue in
22 ’96 or ’97, but isn’t that the exercise we’re going through today instead of
23 having done it in ’97? Is this or isn’t this an extraordinary expense that should
24 be amortized over five years?

A. You have that choice before you, yes, that’s true.

Q. And also, when we do the accounting petitions, as I recall,
when they are done timely, which seems to be the better method, do we
approve them or don’t we have some language in there that we’re not actually
finally approving the prudence of them, if that’s the right word, until the next rate
case?

A. Yes, that’s true.

Q. So whether or not it was filed “when it should have been” or
today, isn’t the ultimate decision on it, doesn’t it wait until the next rate case
anyway?

A. For the prudence of the expense itself, usually in the accounting
petitions you’re only giving the company permission to take what would be an

1 ongoing expense for the year and allowing them to put it on their balance sheet
2 instead so that it doesn't look so bad on their financial statements.

3 CHAIRWOMAN SHOWALTER: I see, thanks."

4 Q. Did the Company file its accounting petition to be able to defer the extraordinary
5 increase in power supply costs on its financial and regulatory balance sheet pending future review
6 of the Commission?

7 A. Yes. It's my understanding that is the main function for filing an accounting
8 petition with the Commission. We had been put on notice that petition should be filed timely. We
9 did that. GAAP requires some recognition from a Company's regulators that it is appropriate for
10 a Company to defer for future review costs that would otherwise be expensed currently. We
11 obtained that. A final Commission determination will be used by the Company to determine how
12 much of the deferred costs are appropriate to keep on its balance sheet and be used for
13 authorized ratemaking.

14 **CREATE A LIABILITY FOR REVENUES SUBJECT TO REFUND**

15 Q. Why do you oppose the Staff's recommendation to create a liability on the
16 Company's balance sheet, in FERC Account 254-Other Regulatory Liabilities?

17 A. That proposal does nothing to improve the Company's situation with regards to
18 dealing with the financing issues. In fact, it doesn't advance the process in any meaningful way.

19 Q. Please expand on that point?

20 A. The Staff incorrectly assumes recording the emergency revenue in a deferred
21 liability account provides an **offset** to the deferred power costs already on the balance sheet.
22 That couldn't be more wrong. The additional liability, or burden on the balance sheet, in
23 conjunction with all the Staff testimony surrounding recovery, will only serve to create a short-term

1 loan of 90 days, “subject to refund.” The power cost deferral balance would not be directly
2 offset.

3 Q. How does the Staff accounting proposal impact the Company’s issue with meeting
4 the covenant tests associated with its recent financings?

5 A. Creating a liability instead of amortizing a portion of the deferral balance doesn’t
6 help with the financial covenant calculations in any way. Company witness Mr. Eliassen will be
7 addressing that result in more detail. The creation of a new liability only complicates the existing
8 accounting and provides investors no positive regulatory message for the Company in Washington.

9 Q. Did you discuss this issue with the Staff prior their filing of their direct case?

10 A. Yes. I participated in a multiple person conference call where the Company
11 expressed the same concern.

12 Q. What does the Company propose as an alternative?

13 A. The Company should be allowed to record any increase in rates as current
14 revenue and amortize an associated portion of the power cost deferrals as an offsetting current
15 period expense.

16 Q. Why is this approach more favorable than the Staff proposal?

17 A. If we are going to be allowed to increase customer’s rates, it would be critical to
18 try to maximize the benefit that increase in rates provides to our situation with obtaining adequate
19 financing for ongoing operations.

20 Q. What about Staff concerns that any increase in rates not be tied to a deferral
21 balance that hasn’t received final Commission approval for recovery?

22 A. In my opinion, it is reasonable to assume that the Company, after a full review, will
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1 be able to recover in some way all or at least a majority of the deferred power costs incurred for
2 service to our customers. The Staff is currently proposing a very short 3-month period for any
3 initial increase to be in effect. (Company witnesses have already commented on the
4 inappropriateness of limiting the surcharge duration to three months.) Even with the Company's
5 proposed increase of 36.9% that would only reduce the deferral balance by approximately \$20
6 million during October through December. Current Company estimates show the Washington
7 deferral balance to be approximately \$200 million by the end of this year, 2001. Under those
8 assumptions, even if the Commission found that virtually 90% of the power cost deferrals, or
9 almost \$180 million, are not recoverable, no refund would be triggered.

10 Q. What would the Company be required to do if a portion of the deferred power
11 costs are determined to not be recoverable?

12 A. If a portion of the deferred power costs is ultimately not allowed recovery through
13 rates, the Company would be required to reduce the balance sheet account through a write-off at
14 that time. Any change or modification to the recoverable balance could be taken into account by
15 modifying either the amount or duration of any surcharge or rate increase that is in place at the
16 time.

17 RATE DESIGN

18 Q. Do you agree with Mr. Parvinen's proposal to apply the proposed surcharge on a
19 uniform cents per kwh to all customers (except street and area lighting)?

20 A. No. I do not agree that a uniform cents per kwh application, as proposed by Mr.
21 Parvinen, is preferable from a cost-causation standpoint. However, because of the magnitude of
22 the proposed increase, the disparity in the resulting percentage increase to different customers is

1 an overriding concern.

2 Q. Could you please explain?

3 A. Even under the Staff's overall proposed surcharge of 32.6%, the percentage
4 increase to customers would range from 22.5% to 48% under a uniform cents per kwh increase,
5 as proposed by Mr. Parvinen. I believe that this level of disparity is just too large. The customers
6 that would receive the 48% (or higher) increase would be the Company's largest industrial,
7 commercial, and institutional customers. It should also be noted that the recently filed tariff for the
8 BPA Residential Exchange Credit does not benefit these customers.

9 Q. Part of Mr. Parvinen's reasoning for proposing a uniform-cents per kwh for all
10 general service customers is that it would be easier to "track and verify" as compared to a
11 different rate for each service schedule. Do you agree with his assertion?

12 A. I agree that a single rate per kwh would be slightly easier to administer and verify.
13 However, the small amount of additional administrative work required should not be a primary
14 factor considered in the spread of the proposed surcharge. The Company has only five general
15 service schedules and the sales under each schedule are easily identified.

16 Q. Does that conclude your rebuttal testimony?

17 A. Yes, it does.

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