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**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**DOCKET NO. UE-991606**

**DOCKET NO. UG-991607**

**REBUTTAL TESTIMONY OF JON E. ELIASSEN**

**SENIOR VICE PRESIDENT & CHIEF FINANCIAL OFFICER**

**OF AVISTA CORPORATION**

WUTC
DOCKET NO. UE-991606
EXHIBIT # T-520
ADMIT W/D REJECT

**Exhibit No. T-__ (JEE-T)**

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

A. My name is Jon E. Eliassen. My business address is 1411 East Mission Avenue. I am employed by Avista Corporation (Company) as the Senior Vice President and Chief Financial Officer.

Q. As the Senior Vice President and Chief Financial Officer, what are your responsibilities?

A. My duties include responsibility for the Finance, Corporate Development, Investor Relations and Corporate Systems Department functions for the Company and its subsidiaries relating to all financial transactions, internal and external reporting, receipts and disbursements, property, investments, taxes, issuance of securities, information systems along with acquisition and divestiture activities of the Company.

Q. What is the purpose of your rebuttal testimony in this case?

A. My purpose is to respond to the testimonies of Dr. Richard J. Lurito, on behalf of the Washington Utilities and Transportation Commission (WUTC) Staff, and Mr. Stephen G. Hill, on behalf of the Washington Attorney General Public Counsel, concerning the cost of capital for the Company's jurisdictional electric and gas utility operations.

My rebuttal testimony includes the following points:

1. Business risk in the electric and natural gas industry continues to increase.
2. The level of common equity required to finance the electric and natural gas industry is increasing.
3. The Company's credit rating outlook and cost of capital has already been impacted by the staff proposals in this case.

4. The Company's credit and business risk profile and its access to cost-effective capital will be negatively impacted if the staff and/or intervenors' positions are adopted.
5. The Company's cash position will be significantly and adversely impacted if the staff's positions are adopted.
6. The Company's proposed capital structure and rate of return requested fairly balances the Company's future financial strength with the need to maintain competitive energy prices.
7. My overall conclusion is that evidence in this proceeding continues to support the Company's proposed rate of return of 9.93%, including a return on equity of 12.25%.

Q. Briefly summarize your views on the overall rates of return recommended by Dr. Lurito and Mr. Hill.

A. The 8.82 percent overall rates of return recommended by Dr. Lurito and Mr. Hill do not recognize the appropriate costs of capital or capital structure for the Company's utility operations. In my opinion, both significantly understate the true cost of financing the Company's utility operation.

Q. Do you agree with their observations about the changes occurring in the utility industry?

A. Yes, the industry has undergone and is continuing to experience significant changes that change investor perceptions and expectations about the industry. Dr. Lurito and Mr. Hill, however, have failed to draw the appropriate conclusions about the effect of these developments on our cost of capital, as I will discuss later in my testimony.

Q. Are there specific changes that you feel have heightened investor perceptions of increasing risk in the electric utility industry?

A. Yes. Because the staff and intervenors reject the Company's proposed PCA mechanism, increasing volatility in the energy marketplace will lead to increased business risk for the Company. Exposure to power price variability is becoming a more significant risk for electric utilities. As shown by Witness Norwood in his Exhibit __(KON-10), page

1, the cost of short-term purchased power has increased dramatically over the past four years—by over 110%. This significant increase in energy prices increases the risk that the Company will be unable to recover the entire cost of providing energy to retail customers, especially without a PCA. In addition, the extreme volatility in short-term prices, such as those power prices experienced in the summer of 1999 and recently in 2000, can have a significant impact on costs and the operating results for the Company's electric utility operations. Without any offsets, the increased energy price volatility will result in investors perceiving higher risks and requiring higher returns.

Q. Are there other areas that could impact the credit rating or the risk profile of the Company?

A. Yes. A significant issue is the staff recommendation relating to the financial restructuring of the Portland General capacity contract. The proposal by the staff would have a significant and immediate negative impact on cash requirements of at least $56 million, and would increase the amount of new financing that would be required in the next few years. The Company does not currently generate enough cash to fund its annual construction requirements, along with our total dividend requirements. This proposal only makes the situation worse.

More importantly, the proposal by staff would suggest we eliminate some of the lowest cost financing that we currently have, by "paying off" the lease on the Rathdrum generating plant. Not only would we reduce future cash flows as a direct result of this proposal, we would also have to borrow the cash at a higher interest rate than we currently have "locked-in" for the next five years.

The effect of the staff's proposal is to manage the financial decision-making process of the Company. In my opinion, their proposal would be viewed very negatively by investors, our banks and the credit rating agencies.

Q. Does the staff and Public Counsel take issue with the Company's proposed hypothetical capital structure?

A. Yes, they do. As I discuss later in my testimony, I disagree with various elements of their proposed capital structures. A comparison of the three proposals are as follows:

| | Company | Staff | Public Counsel |
|---|---|---|---|
| Long-term Debt | 47.00% | 40.00% | 46.03% |
| Short-term Debt | 0.00% | 8.50% | 4.55% |
| Preferred Stock | 6.00% | 9.50% | 10.45% |
| Common Equity | 47.00% | 42.00% | 38.97% |
| Total | 100.00% | 100.00% | 100.00% |

Q. Have you observed any changes in utility capital structures as the industry has been undergoing these changes?

A. Yes, I have reviewed information on utility capital structures over the 10-year period from 1989-98 and noted a general trend of increasing common equity ratios. Moody's Electric Utility Industry Outlook summarizes overall statistics for the industry. As shown in my Exhibit __(JEE-1), page 1, actual data on the average common equity ratio as reported by Moody's has increased from 41.3 percent in 1989 to 45.2 percent in 1998.

Q. Does this trend surprise you?

A. No. In fact I believe it should be expected as an industry undergoes changes that increase risk from an investors standpoint. As earnings and cashflows become more volatile and uncertain, business risk is increasing, and it is necessary to adjust the debt and equity ratios to maintain investment grade credit ratings.

Q. Have you observed any other trends in financial indicators for the utility industry?

A. Yes. The average credit rating for the industry has been declining over the past several years and rating agencies have stated that they expect further downward pressure as the industry changes. During my ongoing discussions with the rating agencies, they have stated that they tend to view generation, unless fully included in rate base, and significant purchased power obligations as a higher risk than the distribution and transmission portions of the business. They also view both capital additions which increase at a much faster rate than customer or revenue growth and relatively weak cash generation as negatives as well. This emphasizes the need to maintain a stronger rather than weaker equity ratio for the utility business now and into the future. Risk can be somewhat mitigated if the Company is allowed the opportunity to earn its true cost of capital and fully recover its purchased power costs through a PCA, especially as price volatility continues to increase.

Q. Why is it important for Avista utility operations to maintain investment grade credit ratings?

A. The utility operations continue to have needs for external capital. Utility capital expenditures for the ten-year period from 1990-99 totaled $988.5 million, an average of nearly $100 million annually. Total capital expenditures for non-regulated businesses over the same ten years amounted to $108.6 million. Utility capital expenditures are expected to be $320 million over the next three years. In addition to these needs for capital, there will also be debt and preferred stock maturities of $137 million over the next three years. The internal cash generated by utility operations for the same period is expected to be $334 million, or $123 million less than total needs, so access to capital at a reasonable cost continues to be important. And at a time when competition for funds in the capital markets is keen, it is imperative that the Company maintains maximum flexibility, which is greatly assisted by maintaining investment grade ratings.

Q Please comment on the capital structures proposed by Dr. Lurito and Mr. Hill.

A. Both witnesses recommend capital structures which could put downward pressure on the Company's credit rating and reduce the Company's flexibility to finance the business. The total debt ratio recommended by Dr. Lurito is 48.5% and Mr. Hill recommends a debt ratio of 50.58%. Given the Company's business position rating of "5" by Standard & Poors, the debt ratio would be within the "BBB" rating category under S&P guidelines. While this is an investment grade level, it is not a preferable rating level over the long term. I believe a higher rating is desirable to provide financing flexibility.

Q. Are there other factors that need to be considered when determining the appropriate debt ratio?

A. Yes. There has been no recognition by either Dr. Lurito or Mr. Hill of the debt vs. equity treatment by rating agencies for various classes of preferred stock. When this information is factored into the proposed capital structures, the additional leverage becomes apparent. Standard & Poor's news release in February 1999 announced that:

> "it is revising the equity credit it assigns to various hybrid securities that feature both debt and equity characteristics. Standard & Poor's is generally reducing the amount of equity credit it assigns to preferred stock

> and other, related securities when issued by corporate entities other than insurers and banks. The equity credit afforded to trust preferred, in particular, drops from 75% of common equity to 40%."

This implies that the debt credit for the securities increases from 25% to 60%. In addition, S&P listed the equity credit it would assign to other classes of securities as follows:

| **Security** | **Equity Credit** |
|---|---|
| Mandatory Conversion Preferred within 3 years | 80% |
| Convertible Preferred MIPS | 60% |
| Conventional Perpetual Preferred | 50% |

Applying these factors to Avista's preferred securities would increase the debt ratio by approximately 6 percentage points, which would produce debt ratios of 54.5 percent and 56.58 percent based on the capital structures recommended by Dr. Lurito and Mr. Hill. Debt at this level would equate to a rating in the bottom of the "BBB" category or the top of the "BB" category based on S&P's guidelines. Falling below investment grade (BBB) would be unacceptable and would significantly limit our ability to finance the Company, and, to the extent we could finance, would impose additional costs on customers.

Q. Should short-term debt be included as a separate component of the capital structure?

A. Conceptually, I do not believe it makes sense to include short-term debt in a capital structure intended to finance long-lived assets such as those in a utility rate base. Short-term debt is not a permanent source of capital and is generally outstanding for less than 30 days. Our committed bank lines of credit must be renewed annually, and much of the short-term money we borrow comes from uncommitted bank facilities. In addition, the balance can vary widely day to day and month to month. This can be seen on page 2 of my Exhibit ___(JEE-1) which shows several points in time when there was no short-term debt outstanding. The intent of short-term borrowings is to allow the Company to finance cash needs on a temporary basis until longer-term financing can be secured. Since no short-term assets are included in rate base (such as working capital, which does have a carrying cost associated with it and is necessary to run a utility business), it does not make sense to me to include short-term borrowings in the capital structure.

Q. If short-term borrowings are included in the capital structure, how should the amount be determined?

A. Since the balance varies so much, it would certainly make no sense to take the balance at a point in time. If included, conceptually an average balance of short term debt as proposed by Mr. Hill would be more appropriate. If the Commission adopts an average balance of short term debt, I believe the appropriate level to be included is $45 million, which is our actual average balance over the past four years, and is shown on page 2 of my Exhibit ___(JEE-1).

Q. What would the proper cost of short-term debt be if it were included in the capital structure?

A. This is an additional difficulty of including short-term debt in the capital structure. The cost fluctuates daily based on a variety of factors and the cost can be higher or lower than the embedded or current costs of longer-term debt. The historical costs can be significantly different than those currently being incurred, or that will be incurred in the coming months. This can be seen on page 2 of my Exhibit___(JEE-1).

. The data shows we have incurred costs of short term debt ranging from 5.7% to 7.0% during the past five quarters. Rates have continued to move up since December 1999 as shown on page 3 of my Exhibit___(JEE-1). Additional increases are anticipated in the coming months. Given this uncertainty, the cost of short-term debt should be based on the most current actual rates the Company is experiencing. The annualized cost of short term debt as of May 26, 2000 was 7.49 percent as shown on page 2 of my Exhibit ___(JEE-1). If any average level of short-term debt is included in the capital structure, a reasonable short-term debt cost would be at least 7.00%.

Q. In your opinion, what is an appropriate debt ratio for the Company's regulated utility operations?

A. In my opinion, a debt ratio in the range of 45 to 50 percent, including the debt equivalent portion of preferred stock is appropriate. The Company's proposed debt ratio of 47% is within this range.

Q. Are there other capital structure issues you would like to address?

A. Yes. I disagree with Mr. Hill's assertion at page 18 of his Exhibit T-___(SGH-T) that adopting the capital structure recommended by the Company and Dr. Avera in this case "...would constitute financial cross-subsidization of the unregulated operations by regulated ratepayers." It is correct that the Company's equity ratio as of the end of 1999 was less than the equity ratio proposed in this case. However, that ratio was as of a single point in time and was temporarily lower than historical levels as a result of the timing of certain financial transactions. I will discuss those transactions in more detail in a moment. The key point to recognize in the capital structure proposed by the Company is that it is the structure we believe is necessary over the long-term to maintain investment grade credit ratings and allow continued access to capital at reasonable costs.

Regarding the 1999 year-end equity ratio, there were two unusual financial activities during 1998 and 1999 that caused the ratio to be below our historical levels. The first was the issuance of convertible preferred stock in 1998 as a way to allow income-oriented investors to maintain dividend income for a three-year period when the Company cut its common dividend rate. This preferred stock was manditorily convertible to common stock within three years, and was in fact converted in early 2000. Therefore, this is appropriately included as common equity. The other financial transaction involved the buyback of common shares by the Company. The buyback was done by the Company in response to the Company's belief that the common shares were undervalued by the market. The Company's intent was to repurchase the shares while undervalued and then reissue shares at a later date when the stock price reflected a more reasonable value.

Q. What was the temporary impact on the equity ratio from the stock buyback transactions?

A. The Company repurchased 9.13%, or 5.1 million shares of the common and convertible preferred shares during 1999, which reduced the common equity balance by $87.9 million. The impact on the equity ratio from the repurchase was a temporary decrease in the equity ratio of approximately 5.8 percentage points. If we add this and the convertible preferred stock back to the actual common equity ratio at December 31, 1999, the common equity ratio would have been 49.0 percent. This is higher than the equity ratio proposed in this case and does not support Mr. Hill's assertion that the utility operations would be subsidizing the non-regulated operations.

Q. What evidence is there that this is a temporary situation and that the Company intends to issue new common stock?

A. As authorized by the Company's Board of Directors in February this year, on May 3, 2000 the Company filed an application with this commission and the other state commissions that regulate our operations to issue 3.7 million new common shares. No issuance can occur until all jurisdictions have ruled on our application. In fact, the Commission issued its order in this proceeding on May 30, 2000. If the Company were to issue just 1.5 million new shares of common stock, at an assumed price of $25, the resulting equity increase of $37 million would raise the common equity ratio by approximately 2%. Obviously, it will be necessary to issue common equity if the staff proposal relating to the PGT contract monetization is adopted.

Q. Was the stock buyback a successful strategy?

A. Yes, clearly, in my opinion. Shares were repurchased at an average price significantly below the share price today, so that as the Company issues new shares in the future the anticipated benefits will occur.

Q. What is your view of the appropriate capital structure for Avista's utility operations?

A. In my opinion, I believe a capital structure consisting of 45 to 50 percent common equity, 4 to 7 percent preferred equity (as adjusted for the appropriate equity credit), and 45 to 50 percent debt (adjusted for the debt equivalent of preferred securities) will allow the Company to finance its utility operations at a reasonable cost. The structure proposed by Company witness Avera falls within these ranges. Above all, the capital structure must be set so as to balance the opportunity to provide adequate returns to investors with the need to maintain regionally competitive pricing of energy products.

Q. Do you have any observations on the recommended allowed return on equity?

A. I believe investors will be concerned and alarmed by the levels of equity returns suggested by Dr. Lurito (10.40%) and Mr. Hill (10.875%). Even if we were to rely only on the evidence presented by Dr. Lurito, as presented on page 16 of his Exhibit T-___(RJL-T), an average allowed return on equity for companies with utility operations similar to Avista is 11.4 percent and those same companies' actual average earned return on equity in 1999 was 11.3 percent. Mr. Hill presents evidence for another similar group of companies that shows the average cost of equity is approximately 11.3 percent (excluding Alliant Energy which seems to be an unusual case) and the average expected earned return for 2000 to be 12.06 percent. Company witness Avera presents a group of companies with an average allowed RETURN ON EQUITY of 11.7 percent. The data seem quite consistent to me. If these are indeed comparable companies as asserted by all the witnesses, then the return on equity (excluding any adjustments related to good management) should be in the 11.3 to 11.7 percent range. Adding in adjustments for financing costs and management effectiveness results in a range of 11.8 to 12.2 percent, which is consistent with the Company's request in this case.

Q. Have you identified any other evidence to show that a return on equity in this range is reasonable?

A. Yes. In approaching this issue from the perspective of the broader industry, I have reviewed information on recently granted returns on equity. So far during 2000, most allowed return on equity have been in the range of 11.2% to 11.5%, as reported in an April 5, 2000 report from Regulatory Research Associates, Inc. More importantly, these returns need to be looked at in conjunction with the capital structures that were approved at the same time. The average common equity ratio allowed in these decisions was 49.75 percent, which is significantly higher than the common equity ratios recommended by Dr.

Lurito and Mr. Hill or even proposed by the Company in this case. In my opinion, this provides additional evidence that the return on equity and related equity ratio requested by the Company in this case is reasonable.

Q. What do you believe a reasonable overall rate of return would be?

A. I believe the evidence in this proceeding continues to support the Company proposed rate of return on 9.93%.

Q. Does that conclude your testimony?

A. Yes it does.