Exhibit No. ____ (MTT-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-09________

DOCKET NO. UG-09________

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

4 A. My name is Mark Thies. My business address is 1411 East Mission Avenue,
5 Spokane, Washington. I am employed by Avista Corporation as Senior Vice President and Chief
6 Financial Officer.

7 **Q. Would you please describe your education and business experience?**

8 A. I received a Bachelor of Arts degrees in Accounting and Business Administration
9 from Saint Ambrose College in Davenport, Iowa, and became a Certified Public Accountant in
10 1987. I have extensive experience in finance, risk management, accounting and administration
11 within the utility sector, primarily in the Midwest.

12 I joined Avista in September of 2008 as Senior Vice President and Chief Financial
13 Officer (CFO). Prior to joining Avista, I was Executive Vice President and CFO for Black Hills
14 Corporation, a diversified energy company, providing regulated electric and natural gas service to
15 areas of South Dakota, Wyoming and Montana. I joined Black Hills Corporation in 1997 upon
16 leaving InterCoast Energy Company in Des Moines, Iowa, where I was the manager of
17 accounting. Previous to that I was a senior auditor for Arthur Anderson & Co. in Chicago,
18 Illinois.

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

20 A. I will provide a financial overview of the Company and will explain the overall
21 rate of return proposed by the Company in this filing for its electric and natural gas operations.
22 The proposed rate of return is derived from Avista's total cost of debt including long-term and

1 short-term cost of debt, and common equity, weighted in proportion to the proposed capital
2 structure.

3 I will address the proposed capital structure, as well as the proposed cost of total debt and
4 equity in this filing. Company witness Dr. Avera will provide additional testimony related to the
5 appropriate return on equity for Avista, based on the specific circumstances of the Company,
6 together with the current state of the financial markets.

7 In brief, I will provide information that shows:

8 • Avista's plans call for significant capital expenditure requirements for the utility
9 over the next two years to assure reliability in serving growth in the number of
10 customers and customer demand. Capital expenditures of approximately $420
11 million are planned for 2009-2010 for customer growth, investment in generation,
12 transmission and distribution facilities for the electric utility business as well as
13 necessary maintenance and replacements of our natural gas utility systems. Avista
14 needs adequate cash flow from operations to fund these requirements, together
15 with access to capital from external sources under reasonable terms.
16
17 • Avista's corporate credit rating from Standard & Poor's is currently BBB- and
18 Baa3 from Moody's. Avista Utilities needs to operate at a level that will support a
19 strong investment grade corporate credit rating, meaning "BBB" or "BBB+", in
20 order to access capital markets at reasonable rates, which will decrease long-term
21 costs to customers. Maintaining solid credit metrics and credit ratings will also
22 help support a stock price necessary to issue equity to fund capital requirements.
23
24 • The Company has proposed an overall rate of return of 8.68%, including a
25 47.51% equity ratio and an 11.0% return on equity. We believe the 11.0%
26 provides a reasonable balance of the competing objectives of continuing to
27 improve our financial health, and the impacts that increased rates have on our
28 customers.
29
30 The Company's initiatives to carefully manage its operating costs and capital
31 expenditures are an important part of improving performance, but are not sufficient without
32 revenues from the general rate request for our electric and natural gas businesses in these cases.
33 Certainty of cash flows from operations can only be achieved with the continued support of

1 regulators in allowing the timely recovery of costs and the ability to earn a fair return on
2 investment.

3 Finally, I will provide testimony concerning the Company's pension expense and its
4 proposal for a balancing account with respect to annual dollar differences between cash payments
5 and pension expense.

6 A table of contents for my testimony is as follows:

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17 **Q. Are you sponsoring any exhibits with your direct testimony?**

18 A. Yes. I am sponsoring Exhibit No.___(MMT-2) pages 1 through 5, which were
19 prepared under my direction. Avista's credit ratings by the three principal rating agencies are
20 summarized on page 1, and Avista's actual capital structure at September 30, 2008 and pro forma
21 capital structure at December 31, 2010 are included on page 2, with supporting information on
22 pages 3 through 5 of the exhibit.

23

24 **II. FINANCIAL OVERVIEW**

25 **Q. Please provide an overview of Avista's financial situation.**

1 A. The Company has made solid progress in improving its financial health in recent
2 years, as demonstrated by improved financial ratios. Avista has reduced investments in
3 unregulated subsidiaries and redeployed the majority of the proceeds from the sales of the
4 unregulated subsidiaries to the Utility. The Company has been able to improve its debt ratio and
5 balance the overall debt / equity ratio by paying down debt, issuing additional common stock,
6 and through additional retained earnings. Although we have made progress in improving the
7 Company's financial condition, we are still not as strong as we need to be given the current
8 unrest in capital markets, which may continue for some time.
9 Avista's goal is to operate at a level that will support a strong corporate credit rating of
10 BBB / BBB+, and move away from the "cliff" of the investment grade rating scale. Operating at
11 a higher rating will help reduce long-term costs to customers. It will also reduce collateral
12 requirements and allow us to maintain access to more counterparties for acquisition of natural
13 gas and electricity. We expect that a continued focus on the regulated utility, conservative
14 financing strategies (including the issuance of common equity) and a continued supportive
15 regulatory environment will contribute to an overall improved financial situation, that will allow
16 us to move up from the current BBB- rating.
17 **Q. What additional steps is the Company taking to improve its financial health?**
18 A. We are working to assure we have adequate funds for operations, capital
19 expenditures and debt maturities. We recently acquired a new $200 million 364-day line of
20 credit from our banks at reasonable rates that has allowed us to avoid the debt capital markets at
21 a volatile time when rates are very high. In December 2008, we also obtained a $30 million
22 private placement of five-year debt at favorable rates as compared to the public markets.

1 We are maintaining our original $320 million line of credit, which will expire in April
2 2011, as well as our Accounts Receivable Sales program. The Company plans to obtain a
3 portion of our capital requirements through equity issuance. We also maintain an ongoing
4 dialogue with the rating agencies regarding the measures taken by the Company to improve our
5 credit rating.

6 Additionally, the Company is working through regulatory processes to recover our costs
7 in a timely manner so that earned returns are closer to those allowed by regulators in each of the
8 states we serve. This is one of the key determinants from the rating agencies' standpoint when
9 they are reviewing our overall credit standing.

10 **Q. In addition to having credit ratings that will allow Avista to attract debt**
11 **capital under reasonable terms, is it also necessary to attract capital from equity investors?**

12 A. It is absolutely essential. Avista has two primary sources of external capital –
13 debt lenders and equity investors. Avista currently has approximately $2.0 billion of net
14 investment in place to serve its customers. Approximately half of that investment is funded by
15 debt holders, and half is funded by equity investors. Therefore, even though there tends to be a
16 lot of emphasis on maintaining credit metrics and credit ratings that will provide access to debt
17 capital under reasonable terms, access to equity capital is equally important.

18 Additional equity capital generally comes in two forms – retained earnings and new
19 equity issuances. Retained earnings represent the annual earnings (return on equity) of the
20 Company that is not paid out to investors in dividends. The retained earnings are reinvested by
21 the Company in utility plant, and other capital requirements, to serve customers, which avoids
22 the need to issue new debt. Occasionally it is necessary to issue new common stock to maintain

1 the proper balance of debt and equity in the capital structure, which allows Avista access to both
2 debt and equity markets under reasonable terms, on a sustainable basis. Because of the large
3 capital requirements at Avista in the near-term, it is imperative that Avista have ready-access to
4 both the debt and equity markets at reasonable costs.

5 **Q. Are the debt and equity capital markets a competitive market?**

6 A. Yes. Our ability to attract new capital, especially equity capital, under reasonable
7 terms is dependent on our ability to offer a risk/reward opportunity that is better than the equity
8 investors' other alternatives. We are competing with not only other utilities, but businesses in
9 other sectors of the economy. As an example, if an equity investor believes, or perceives, that
10 the risk/reward opportunity is better with Wal-Mart than with Avista, or the utility industry in
11 general, the investor will put the equity dollars in Wal-Mart stock. Demand for the stock
12 supports the stock price, which provides the opportunity to issue additional stock under
13 reasonable terms to fund capital investment requirements.

14 To the extent that the equity investor holds a diversified portfolio of companies that
15 includes utilities and other energy companies, we would be competing with those companies to
16 attract those equity dollars.

17 In the debt markets, utilities are the third largest issuers, right behind governments and
18 financial services. Therefore, it is a very competitive market and the Company must be able to
19 attract debt investors as well as equity investors.

20 **Q. What is Avista doing to attract equity investment?**

1 A. Avista is carrying a capital structure that provides the opportunity to have
2 financial metrics that offer a risk/reward proposition that is competitive and/or attractive for
3 equity holders.

4 We have increased our dividend for common shareholders, and have publicly stated that
5 we intend to work toward a dividend payout ratio that is comparable to other utilities in the
6 industry. This is an essential element in providing a competitive risk/reward opportunity for
7 equity investors.

8 We are operating the business efficiently to keep costs as low as practicable for our
9 customers, while at the same time ensuring that our energy service is reliable, and results in a
10 high level of customer satisfaction. An efficient, well-run business is not only important to our
11 customers, but also to investors.

12 We are employing tracking mechanisms such as the Energy Recovery Mechanism (ERM)
13 and Purchased Gas Adjustment (PGA), approved by the regulatory commissions, to balance the
14 risk of owning and operating the business in a manner that places us in a position to offer a
15 risk/reward opportunity that is competitive with not only other utilities, but with businesses in
16 other sectors of the economy.

17 We are seeking rate relief to provide timely recovery of costs and earned returns closer to
18 those allowed by regulators. If we are not able to achieve a reasonable, actual, earned return on
19 our equity investment, we will not be able to attract equity dollars that are absolutely necessary to
20 support this business going forward.

1 Dr. Avera provides additional testimony related to the appropriate return on equity for
2 Avista, that would allow the Company access to equity capital under reasonable terms, and on a
3 sustainable basis.

4 **Q. Do you believe there are misconceptions about the earnings of the Company**
5 **related to the equity investment in the Company?**

6 A. Yes I do. I believe some of our customers believe that the earnings of the
7 Company that we report publicly each quarter are "profits" that are over and above the dollars
8 necessary to own and operate the utility, which we know is simply not true. Just as we must pay
9 interest to debt holders in exchange for the use of their dollars, we must also provide a return on
10 investment for the equity holder, or the equity holder will take his or her dollars somewhere else.

11 I believe some do not understand that the quarterly earnings or profits are the return or
12 "interest" to the shareholder, and without it we would not have the funds necessary to run the
13 business – i.e., it is, in fact, one of the essential costs of owning and operating the business.

14 **Q. After Avista reported its earnings for the Second Quarter (Q2) of 2008, it**
15 **was reported in the Spokesman Review newspaper that "Avista Quarterly Profits Soar."**
16 **Did Avista's earnings for Q2 of 2008 exceed those authorized by this Commission?**

17 A. No. While earnings from utility operations did improve some for Q2 2008 versus
18 the prior year, the primary reason for the improvement was that Avista Corp completed the sale
19 of Avista Energy during Q2 2007, and recorded a large loss in Q2 2007 related to the operations
20 of that business. The absence of the loss in 2008, resulted in a substantial improvement in
21 reported earnings in Q2 of 2008.

1 **Q. What do the quarterly and annual earnings reported by Avista tell us about**
2 **the earned return for equity holders for 2008?**
3 A. Although actual earnings for the calendar year 2008 have not yet been released,
4 Avista has previously provided "guidance" for the expected earnings for the year. The current
5 earnings guidance for Avista Utilities for 2008 is the range of $1.20 to $1.35 per common share.
6 At September 30, 2008 Avista had approximately 54.0 million common shares outstanding, and
7 an equity investment in the utility of $904 million, per our third-quarter 10-Q filed with the
8 Securities and Exchange Commission. If we were to assume that Avista will see earnings in the
9 middle of the earnings guidance, at $1.28/share, it would result in a return on investment for
10 equity holders of 7.6%. By comparison, the currently authorized return on equity in Washington
11 for Avista is 10.20%. Therefore, during 2008 we expect to earn substantially less than what we
12 were authorized to earn by the WUTC, i.e., we will not recover our costs of providing service to
13 customers, including a competitive return to equity holders.
14 If we continue to fall short, it will threaten our ability to obtain financing from debt and
15 equity holders under reasonable terms.
16 **Q. What is the Company expecting to earn in 2009?**
17 A. We received additional rate relief in all three states where we do business during
18 2008 (January 1, 2009 for Washington). While this provides additional cost recovery, we are
19 also continuing to experience increases in costs, and increased capital investment requirements.
20 As an example, our most recent rate case in Washington included recovery of a majority of the
21 new capital investment through December 31, 2008, but none for 2009 with the exception of the
22 Noxon Unit #1 generation upgrade. What that means is, we are not recovering the costs

1 associated with the new capital investment we have already made in 2009, and will continue to
2 make, until the conclusion of this rate case later this year.

3 Furthermore, if we do not reflect in retail rates the cost of future capital that will be
4 serving customers during the period that retail rates are in place from this case, we will continue
5 to earn a lower return than what we are authorized to earn.

6 We have previously announced that we expect Avista's utility earnings for 2009 to be in
7 the range of $1.30 to $1.45 per share. If we again use the middle of the range ($1.38/share) for
8 illustrative purposes, 54.0 million shares outstanding, and $1.0 billion of equity investment, it
9 would result in an earned return for 2009 of 7.5%, again well below the authorized return of
10 10.2%.

11 As we process this rate filing, it is imperative that we work toward recovery of the costs
12 to provide service to customers, and a meaningful opportunity to earn a return closer to the
13 allowed return, so that we can have access to debt and equity capital under reasonable terms.

14

15 **III. CREDIT RATINGS**

16 **Q. How important are credit ratings for Avista?**

17 A. Utilities need ready access to capital markets in all types of economic
18 environments. I believe few, if any, would have predicted the kind of financial markets we have
19 experienced the past few months. The nature of our business with long-term capital projects, our
20 obligation to serve, and the potential for high volatility in fuel and purchased power markets,
21 necessitates the ability to tap the financial markets under reasonable terms on a regular basis.

1 In these past few months we have seen ample evidence of the benefit of having a higher
2 credit rating. As an example, in December 2008, El Paso Electric, a BB credit, issued bonds at
3 an effective cost of 15%.
4 In the fall of 2008 we had planned to issue an additional $100 million of long-term debt.
5 In April 2008 we issued $250 million of 10-year debt at 5.95%. In the fall of 2008, however,
6 because of the unrest in the financial markets, there were times when we could not issue debt at
7 <u>any</u> interest rate, and when it was available, the all-in interest rates were 9.5% or higher.
8 Fortunately, we were able to negotiate the acquisition of an additional credit line of $200 million
9 for a period of 364 days, under favorable terms, and avoid issuing new long-term debt at these
10 high rates – at least for now. We believe that financial markets will be more stable as we move
11 toward the later part of 2009, and our financial circumstances will be such that we will have
12 access to new long-term debt at reasonable rates.
13 **Q. Yields on US Treasuries have decreased significantly over the past several**
14 **months. Why have interest rates for utility bonds gone up?**
15 A. Although it is true that the yield on US Treasuries has declined, the interest rate
16 spreads between utility bonds and Treasuries that debt holders are demanding have increased
17 dramatically due to the unrest in the financial system and the economy. The following graph
18 illustrates the dramatic rise in the gap during 2008 between the yields on Treasuries and utility
19 bonds rated BBB+, BBB, and BBB- or below. The graph also illustrates the significantly higher
20 cost of debt for companies at or below the lowest rung of the investment grade ladder (BBB- or
21 below), versus a credit rating of BBB, only one step higher than Avista's current rating of BBB-.
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1 **Illustration No. 1:**

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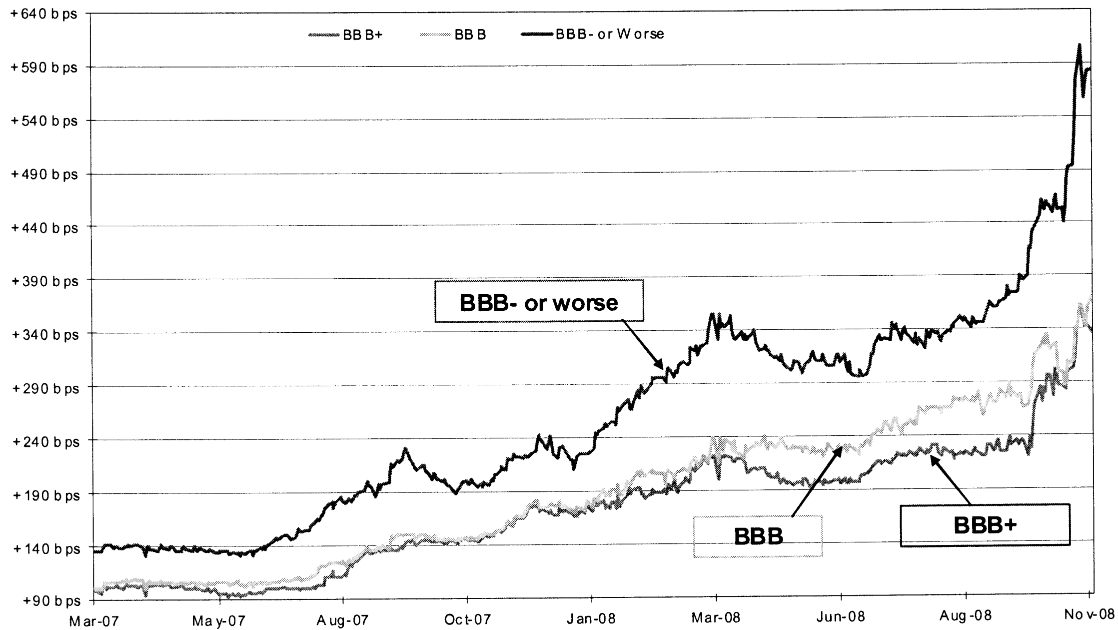


12

13 **Q. Please explain the credit ratings for Avista's debt securities.**

14 A. Rating agencies are independent agencies that assess risks for investors. The three
15 most widely recognized rating agencies are Standard & Poor's (S&P), Moody's Investors Service
16 (Moody's) and FitchRatings (Fitch). These rating agencies assign a credit rating to companies
17 and their securities so investors can more easily understand the risks associated with investing in
18 their debt and preferred stock. Avista's credit ratings by the three principal rating agencies are
19 summarized on page 1 of Exhibit No.___(MMT-2). Additionally, the following rating actions
20 occurred during 2007 and 2008:

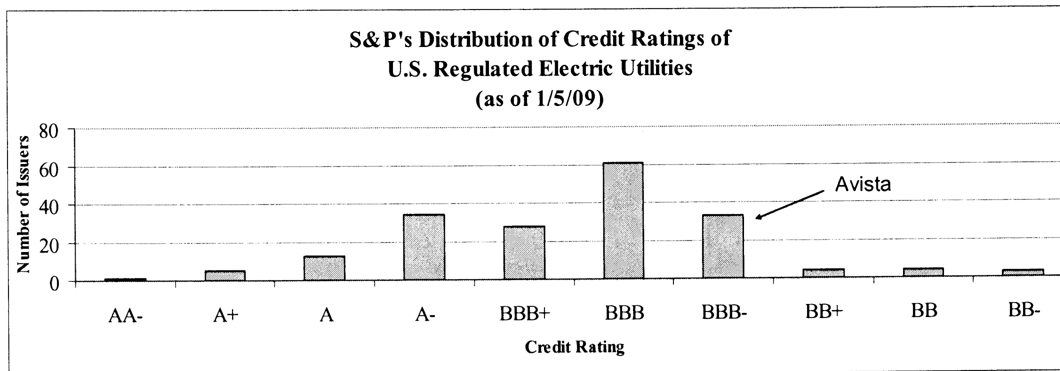
21 a. S&P upgraded Avista's corporate credit rating to BBB- from BB+ (February 2008)
22 and Avista's secured debt rating to BBB+ from BBB- (September 2007 and affirmed
23 in September 2008).

b. Moody's upgraded Avista's corporate credit rating to Baa3 from Ba1 and Avista's secured rating to Baa2 from Baa3 (December 2007).

c. Fitch upgraded Avista's long-term issuer default rating to BB+ from BB and its secured debt rating to BBB from BBB- (August 2007 and affirmed in February 2008).

As shown in Illustration No. 2 below, Avista is on the lowest rung of the investment grade credit rating scale. As I noted earlier, I believe it is important that we move up the scale to at least a BBB or BBB+, so that we are not on the edge of the investment grade cliff.

Illustration No. 2:



Q. Please explain the implications of the credit ratings in terms of the Company's ability to access financial markets.

A. Credit ratings impact investor demand and expected return. More specifically, when the company issues debt, the credit rating helps determine the interest rate at which the debt will be issued. The credit rating also determines the type of investor who will be interested in purchasing the debt. For each type of investment a potential investor could make, the investor looks at the quality of that investment in terms of the risk they are taking and the priority they would have in the event that the organization experiences severe financial stress. Investment

1 risks include the likelihood that a company will not meet all of its debt obligations in terms of
2 timeliness and amounts owed for principal and interest. Secured debt receives the highest ratings
3 and priority for repayment and, hence, has the lowest relative risk. In challenging credit markets,
4 where investors are less likely to buy corporate bonds, a higher credit rating will attract more
5 investors, and a lower credit rating could shrink or eliminate the number of potential investors.
6 Thus, lower credit ratings may result in a company having more difficulty accessing financial
7 markets and/or incur significantly higher financing costs.

8 **Q. What credit rating does Avista Corporation believe is appropriate?**

9 A. The move to investment grade for Avista Corp last year was a significant step in
10 improving the ability to access capital at a reasonable cost. However, a credit rating at the
11 bottom of investment grade is not appropriate for Avista. In adverse conditions – whether unique
12 to Avista or by all market participants – a downgrade from BBB- (investment grade) to BB+
13 (high-yield) is significantly harder to overcome than a downgrade from BBB to BBB-. As Avista
14 experienced, it took approximately six years for the Company to regain its investment grade
15 rating from S&P after it was downgraded during the energy crisis. The difference between
16 investment grade and non-investment grade is not only a matter of debt pricing, it can be a matter
17 of any access at all. During the period from mid-September to mid-December, the credit markets
18 were essentially closed to non-investment grade issuers. In order to be able to weather a
19 potential downgrade, Avista Utilities should operate at a level that will support a strong corporate
20 investment grade credit rating, meaning a "BBB" or an "BBB+," using S&P's rating scale.

21 A solid investment grade credit rating would also allow the Company to post less
22 collateral with counterparties than would otherwise be required with a lower credit rating. This

1 results in lower costs. It also increases financial flexibility since the credit line capacity would
2 not be reduced for outstanding letters of credit.
3 Financially healthy utilities have lower financing costs which, in turn, benefit customers.
4 In addition, financially healthy utilities are better able to invest in the needed infrastructure over
5 time to serve their customers, and to withstand the challenges and risks facing the industry.
6 **Q. What financial metrics are used by the rating agencies to establish credit**
7 **ratings?**
8 A. S&P modified its electric and natural gas utility rankings in November 2007 to
9 conform to the "business risk/financial risk" matrix used by their corporate ratings group. The
10 change by S&P was designed to present their rating conclusions in a clear and standardized
11 manner across all corporate sectors.
12 S&P's financial ratio benchmarks used to rate companies such as Avista are set forth in
13 Illustration No. 3 below.
14 **Illustration No. 3:**

Standard & Poor's Financial Risk Indicative Ratios - US Utilities

	FFO/Debt (%)	FFO/Interest (x)	Debt Ratio (%)
Modest	40 - 60	4.0 - 6.0	25 - 40
Intermediate	25 - 45	3.0 - 4.5	35 - 50
Aggressive	10 - 30	2.0 - 3.5	45 - 60
Highly leveraged	Below 15	2.5 or less	Over 50
12 Month End 9/30/08 Ratios:			
Avista Adjusted*	17.6	3.4	53.7

* Calculated as of 9/30/08 based on last known S&P methodology

1 The ratios above are utilized to determine the financial risk profile. Currently, Avista is
2 in the "Aggressive" category. The financial risk category along with the business risk profile
3 (Avista is in the Strong category) is then utilized in Illustration No. 4 below to determine a
4 company's rating. S&P currently has Avista's corporate credit rating as a BBB-, as indicated in
5 the following illustration.

6 **Illustration No. 4:**

7 **Standard & Poor's Business Risk / Financial Risk Matrix**

8

9

Business Risk Profile	Financial Risk Profile: Minimal	Modest	Intermediate	Aggressive	Highly leveraged
Excellent	AAA	AA	A	BBB	BB
Strong	AA	A	A-	BBB-	BB-
Satisfactory	A	BBB+	BBB	BB+	B+
Weak	BBB	BBB-	BB+	BB-	B
Vulnerable	BB	B+	B+	B	B-

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14 The other rating agencies (Moody's and Fitch) use a similar methodology to analyze and
15 determine utility credit ratings.

16 **Q. Please describe how these ratios are calculated and what they mean?**

17 A. The first ratio, "Funds from operations/total debt (%)", calculates the amount of
18 cash from operations as a percent of total debt. The ratio indicates the company's ability to fund
19 debt obligations. The second ratio, "Funds from operations/interest coverage (x)", calculates the
20 amount of cash from operations that is available to cover interest requirements. This ratio
21 indicates how well a company's earnings can cover interest payments on its debt. The third ratio,
22 "Total debt/total capital (%)", is the amount of debt in our total capital structure. The ratio is an

1 indication of the extent to which the company is using debt to finance its operations. S&P looks
2 at many other financial ratios; however, these are the three most important ratios they use when
3 analyzing our financial profile.

4 **Q. Do rating agencies make adjustments to the financial ratios that are**
5 **calculated directly from the financial statements of the Company?**

6 A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet
7 commitments (for example, the accounts receivable program, purchased power agreements and
8 the unfunded status of pension and other post-retirement benefits) that negatively impact the
9 ratios. S&P has historically made adjustments to Avista's debt totaling approximately $154
10 million related to the accounts receivable program, purchased power and post-retirement
11 benefits. The adjusted financial ratios for Avista are included in Illustration No. 3 above.

12 **Q. Where does Avista fall within those coverage ratios?**

13 A. Avista's cash flow ratios have improved as a result of the refinancing of the high
14 cost debt that matured in June 2008. S&P and Moody's took this into account when they
15 upgraded Avista in December 2007 and February 2008. Progress in increasing the cash flow
16 ratios in recent years has been slower than anticipated due to below normal stream flows
17 affecting hydro generation, higher thermal fuel costs than the amount included in rates and the
18 resulting inability to eliminate electric deferral balances, and higher capital expenditures that
19 require cash up front before we can recover the costs from customers. Each has an impact on the
20 Company by reducing the amount of available cash flow from operations, requiring external
21 financing and ultimately resulting in higher debt and lower cash flow ratios. In fact, S&P stated
22 the following in a January 2008 research report on Pacific Northwest Hydrology:

1 We find that Avista and Idaho Power, which are comparably sized companies,
2 face the most substantial risk (related to hydro power) despite their PCAs and cost
3 update mechanisms.[1]
4
5 Additionally, S&P stated the following in its February 2008 research update of Avista
6 Corporation:

7 The Company's financial performance will continue to be significantly affected by
8 hydro conditions and gas prices. And the Company's key utility risk going
9 forward is its exposure to high-cost replacement power, particularly in low water
10 years.[2]
11
12 In order to improve the cash flow ratios, Avista must reduce its total debt balances and
13 increase its available funds from operations. Although the Company has continued to work
14 towards paying down its total debt, the negative impacts to cash flow caused by below-normal
15 hydroelectric generation and volatility of wholesale electric market prices and natural gas prices
16 in recent years, has adversely affected Avista's progress in improving the cash flow ratios.

17 **Q. Do the rating agencies look at any other factors when evaluating a company's**
18 **credit quality?**

19 A. Yes. In addition to financial ratios and metrics, rating agencies also look at a
20 number of qualitative factors which directly or indirectly may affect a company's cash flow.
21 These factors include:

22 ▪ Regulation
23 ▪ Markets
24 ▪ Operations

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[1] Standard and Poor's, *Pacific Northwest Hydrology and Its Impact on Investor-Owned Utilities' Credit Quality* , January 2008

[2] Standard and Poor's, *Avista Corp's Corporate Credit Rating Raised One Notch to BBB-*, February 2008

1 ▪ Competitiveness, and

2 ▪ Management

3 In evaluating these factors, the rating agencies look for regulatory actions that are
4 supportive of cost recovery and that eliminate or minimize volatility of cash flows. They also
5 consider the strength and growth of the economy in our service territory, operations' ability to
6 control costs, whether our service is competitive, and the effectiveness of management.

7 Therefore, while the ratios are utilized in their quantitative evaluation of a company, they
8 are not the only factors that are taken into account.

9 **Q. What risks are Avista and the utility sector facing that may impact credit**
10 **ratings?**

11 A. Avista's credit ratings are impacted by risks that could negatively affect the
12 company's cash flows. These risks include, but are not limited to, the level and volatility of
13 wholesale electric market prices and natural gas prices for fuel costs, liquidity in the wholesale
14 market (fewer counterparties and tighter credit restrictions), recoverability of natural gas and
15 power costs, stream flow and weather conditions, changes in legislative and governmental
16 regulations, relicensing hydro projects, rising construction and raw material costs, customers'
17 ability to timely pay their bills, and access to capital markets at a reasonable cost.

18 Credit ratings for the utility sector are also adversely impacted by large capital
19 expenditures for environmental compliance, and the need for new generation and transmission
20 and distribution facilities. The utility sector is in a cycle of significant capital spending, which
21 will likely be funded by large issuances of debt and equity. This increases the competition for
22 financial capital at a time when the average utility credit rating is just above investment grade.

1 Given the downturn in the economy and the tightened credit markets, the rating agencies
2 are keeping closer tabs on all companies in order to make sure there is sufficient liquidity in case
3 the credit markets are inaccessible. Not having sufficient sources of cash for potential cash
4 requirements could prompt a credit rating downgrade.

5 The increased capital spending needs and resulting increased debt issuances make
6 regulation supporting the full and timely recovery of prudently incurred costs even more critical
7 to the utility sector than in previous years.

8 **Q. How important is the regulatory environment in which a Company operates?**

9 A. The regulatory environment in which a company operates is a major qualitative
10 factor in determining a company's creditworthiness. Moody's stated the following regarding
11 Avista's regulatory environment in a December 2008 credit ratings report:

12 "Avista benefits from credit supportive ratemaking practices in all three of its
13 jurisdictions, which include periodic mechanisms to account for variations in the
14 power and natural gas costs incurred as compared to the levels included in rates."
15 However, Moody's also pointed out that "Failure to obtain adequate and timely
16 support for recovery of and return on core utility investments through pending and
17 expected future regulatory proceedings, or any unexpected material deviation
18 from the back-to-basics strategy, are among the more important factors that could
19 have negative rating implications."[3]
20
21 Additionally, in a January 2008 article published by S&P entitled "Top Ten US Electric
22 Utility Credit Issues for 2008 and Beyond", S&P stated that "Recovering in a timely manner
23 federally and/or state mandated compliance costs is paramount to preserving credit quality for
24 regulated electric utilities."[4]

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[3] Moody's Investor Service, *Moody's Upgrades Avista Corp* (December 3, 2008)

[4] Standard and Poor's, Top Ten US Electric Utility Credit Issues for 2008 and Beyond, January 2008

1 Due to the major capital expenditures planned by Avista, the continued supportive
2 regulatory environment will be critical to Avista's financial health. Additionally, although Avista
3 has electric and natural gas tracking mechanisms (ERM and PGA) to provide recovery of the
4 majority of the variability in commodity costs, these changes in costs must be financed until the
5 costs are recovered from customers. Investors and rating agencies are concerned about
6 regulatory lag and cost-recovery related to these items.

7 Indeed, as testified to by Company witness Avera, investors recognize that volatile energy
8 markets, and unpredictable stream flows can expose the Company to the risk of reduced cash
9 flows and unrecovered power supply costs. For its part S&P has commented on the risks to
10 Avista, notwithstanding the ERM, and it went on to note that its recovery mechanism is not as
11 strong as Idaho Power's for a number of reasons, including the imposition of "deadbands" which
12 "in recent years have resulted in it absorbing the majority of its cost undercollections[5]."
13
14 **IV. CASH FLOW**

15 **Q. What are the Company's sources to fund capital requirements?**

16 A. The Company utilizes cash flow from operations, long-term debt and common
17 stock issuances to fund its capital expenditures. Additionally, on an interim basis, the Company
18 utilizes its credit facilities to fund working capital needs and capital expenditures until longer-
19 term financing can be obtained.

20 **Q. What are the Company's near-term capital requirements?**

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[5] Standard and Poor's Corporation, "Pacific Northwest Hydrology and Its Impact on Investor-Owned Utilities' Credit Quality," Ratings Direct (January 28, 2008) (p.11)

1 A. As a combination electric and natural gas utility, over the next few years, capital
2 will be required for customer growth, investment in generation, transmission and distribution
3 facilities for the electric utility business, as well as necessary maintenance and replacements of
4 our natural gas systems.

5 The amount of capital expenditures planned for 2009-2010 is approximately $420
6 million. For 2009 alone, these costs equate to a total of $210 million. Total ratebase at
7 November 30, 2008 was $1.9 billion for the total Company; therefore, these planned capital
8 additions represent substantial new investments given the relative size of the Company. A few of
9 the major capital expenditure items on a system basis for 2009 include $60 million for electric
10 transmission and distribution upgrades, $20 million for natural gas system upgrades, $10 million
11 for environmental (associated with the Spokane River relicensing and the 2001 Clark Fork River
12 license implementation issues),and $30 million for generation upgrades.

13 **Q. What are the Company's long-term capital requirements?**

14 A. Avista's Integrated Resource Plan has identified the potential need for the
15 Company to finance significant expenditures for electric facilities. The preferred strategy
16 outlined in our 2007 Integrated Resource Plan included total expenditures of $1.25 billion by
17 2018, including investment in wind resources and upgrades at hydroelectric stations.

18 Major capital expenditures are a normal part of utility operations. Customers are added to
19 the service area, roads are relocated and require existing facilities to be moved, and facilities
20 continue to wear out and need replacement. These and other requirements create the need for
21 significant capital expenditures each year. We saw significant increases in the costs of raw
22 materials over the past year, which our suppliers are continuing to pass through to us in the

1 pricing of their finished products. Access to capital at reasonable rates is dependent upon the
2 Company maintaining a strong capital structure, sufficient interest coverage, and investment
3 grade credit ratings.

4 **Q. What are the Company's near-term plans related to its debt?**

5 A. During 2008 the Company issued $250 million of secured debt in April but, as
6 explained earlier, chose not to go forward with a planned issuance of $100 million in long-term
7 debt in September due to unfavorable conditions in the debt capital markets. The Company
8 instead sought out and was able to establish a second bank line of credit in the amount of $200
9 million for 364 days to ensure continued adequate liquidity. The Company was also offered and
10 accepted a private placement of $30 million of First Mortgage Bond secured 5-year debt.

11 The Company currently plans to issue up to $150 million of secured, fixed rate bonds
12 during 2009. The proceeds from the issuance of the securities will be utilized to fund capital
13 expenditures and repay funds borrowed under our credit facilities. The Company has no long-
14 term debt scheduled to mature in 2009; however, it has an option to redeem $61.9 million of
15 Trust Preferred Securities in March 2009.

16 Illustration No. 5 below shows the amount of debt maturities for Avista each year:

17

18

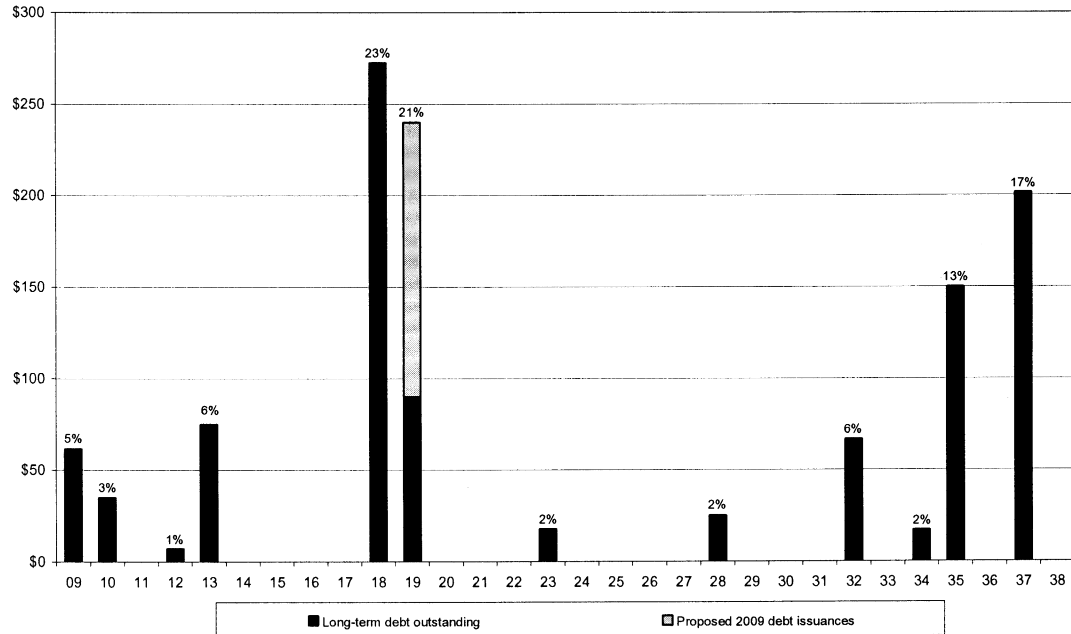
19

20

21

22

1 **Illustration No. 5:**



13 **Q. Has the Company taken any steps to address the uncertainty related to**
14 **interest rate exposure for the planned debt issuance in 2009?**

15 A. Yes. The Company recently entered into four forward-starting interest rate swaps
16 for a total of $100 million as a hedge on a portion of the interest payments on the long-term debt
17 we are planning to issue in 2009. The Company is continuing to analyze the possibility of
18 entering into additional transactions in order to lock in the interest rate on a greater portion of the
19 debt at a time when Treasury rates are at all-time historical lows.

20 **Q. What is the status of the Company's lines of credit secured by first mortgage**
21 **bonds and its accounts receivable program?**

1 A. The Company has a $320 million line of credit that expires in April 2011, and a
2 $200 million line of credit that expires November 24, 2009. The Company has the option of
3 increasing the $320 million line by $100 million (up to $420 million) at any time during the term
4 of the agreement, subject to additional fees and obtaining bank commitments. The agreement
5 includes the option to release the first mortgage bond security when the Company has an
6 investment grade credit rating. The Company also has the option of renewing or upsizing the
7 $200 million deal to $250 million under certain circumstances. Additionally, the Company has
8 an $85 million accounts receivable funding program that expires in March 2009. This agreement
9 has been renewed on a year-to-year basis, and we expect to extend the agreement for another
10 year.

11 The facilities have been sized to allow the Company to maintain a liquidity cushion of at
12 least $125 million at all times to cover required working capital, counterparty collateral
13 requirements, and avoid issuing debt in unfavorable market conditions if they persist through
14 2009. Our liquidity is strong and we are confident that our current agreements give us flexibility
15 while facing both the volatile financial markets and volatile energy commodity prices.

16 Many purchases of natural gas, or contracts for pipeline capacity to provide natural gas
17 transportation, require collateral, and/or prepayments, based upon the Company's credit rating.
18 Upgrades to Avista's credit ratings during 2007 and 2008 have reduced the amount of collateral
19 required to be posted with counterparties. If Avista is upgraded above its current credit ratings,
20 the Company should see an increase in the number of counterparties willing to do business with
21 us and the collateral requirements are expected to decrease even further, resulting in reduced
22 borrowing costs. The lines of credit and accounts receivable program are our primary sources of

1 immediate cash for borrowing to meet these needs and for supporting the use of letters of credit.
2 A line of credit is required to manage daily cash flow since the timing of cash receipts versus
3 cash disbursements is never totally balanced.

4 **Q. What are Avista's plans regarding common equity and why is this**
5 **important?**

6 A. Avista will continue to monitor the common equity ratio of its capital structure,
7 and assess the need to issue additional common equity. Avista entered into a sales agency
8 agreement in December 2006 to issue up to two million shares of our common stock from time to
9 time. During the third quarter of 2008, we issued 750,000 shares of common stock under this
10 agreement. Our plan for 2009 is to continue with the periodic offering of common stock as
11 needed to support the Company's common equity ratio. To the extent that we are not able to
12 access the equity market, there will be increased pressure on our lines of credit, and an increased
13 need to issue long term debt, which is likely to unfavorably impact our cost of debt and debt to
14 equity ratio. It is important to the rating agencies for Avista to maintain a balanced debt/equity
15 ratio in order to minimize the risk of default on required debt interest payments.

16 As Dr. Avera explains in his testimony, the 47.51 percent common equity ratio requested
17 by Avista in this case is consistent with the range of equity ratios maintained by the firms in the
18 Utility Proxy Group.

19 Dr. Avera notes that electric utilities are facing, among other things, rising cost structures,
20 the need to finance significant capital investment plans, and uncertainties over accommodating
21 future environmental mandates. A more conservative financial profile, in the form of a higher
22 common equity ratio, is consistent with increasing uncertainties and the need to maintain the

1 continuous access to capital that is required to fund operations and necessary system investment,
2 even during times of adverse capital market conditions.

3 He also discusses Moody's warning to investors of the risks associated with debt leverage
4 and fixed obligations and their advice to utilities to not squander the opportunity to strengthen
5 the balance sheet as a buffer against future uncertainties. Moody's noted that, absent a thicker
6 equity layer, utilities would be faced with lower credit ratings in the face of rising business and
7 operating risks:

> 8 There are significant negative trends developing over the longer-term horizon.
> 9 This developing negative concern primarily relates to our view that the sector's
> 10 overall business and operating risks are rising – at an increasingly fast pace – but
> 11 that the overall financial profile remains relatively steady. A rising risk profile
> 12 accompanied by a relatively stable balance sheet profile would ultimately result in
> 13 credit quality deterioration.[6]

14 This is especially the case for Avista, which faces the dual challenge of financing
15 significant capital expansion plans in a turbulent market while at the same time endeavoring to
16 improve its credit standing. Avista is committed to maintaining an appropriate level of equity to
17 support a strong credit rating.

18 **Q. What are Avista's plans regarding preferred equity and other financing**
19 **structures (for example, hybrid instruments)?**

20 A. Avista does not have any preferred equity or other financing structures
21 outstanding at December 31, 2008. Currently, Avista does not plan to issue preferred equity or
22 other financing structures, but will continue to evaluate the appropriateness of these financing
23 vehicles.

1 **V. CAPITAL STRUCTURE**

2 **Q. Please explain the capital structure proposed by Avista in this case.**

3 A. Avista's current capital structure consists of a blend of total debt, including long-
4 term and short-term debt, and common equity necessary to support the assets and operating
5 capital of the Company. The proportionate shares of Avista Corp.'s actual capital structure on
6 September 30, 2008, are shown on page 2 of Exhibit No.___(MTT-2). A pro forma capital
7 structure is also shown on page 2, which reflects expected changes for the period ending
8 December 31, 2010. Supporting workpapers provide additional details related to these
9 adjustments on pages 3 through 4.

10 The rate of return to be applied to rate base in this proceeding is equal to the weighted
11 average cost of capital, taking into account the pro forma adjusting items. As shown on page 1
12 of Exhibit No.___(MTT-2), Avista Utilities is proposing an overall rate of return of 8.68%.

13

14 **VI. COST OF DEBT**

15 **Q. How have you determined the cost of debt?**

16 A. Cost of total debt in the Company's proposed capital structure includes long-term
17 debt and the expected monthly average of short-term debt (for the period December 31, 2008
18 through December 31, 2009). As shown on page 2 of Exhibit No.___(MTT-2), the actual
19 weighted average cost of total debt outstanding on September 30, 2008 was 6.51%. The size and
20 mix of debt changes over time based upon the actual financing completed. We have made

[6] Moody's Investors Service, "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008).

1 certain pro forma adjustments to update the debt cost through December 31, 2009 to 6.57%. Pro
2 forma adjustments to total debt reflect expected maturities of outstanding long-term debt,
3 issuance of new debt to fund those maturities and the expected monthly average of short-term
4 debt for the pro forma period. The pro forma weighted cost of total debt was reduced from
5 3.51% to 3.45%.
6
7 **VII. COST OF COMMON EQUITY**

8 **Q. What rate of return on common equity is the Company proposing in this**
9 **proceeding?**
10 A. As further explained by Dr. Avera, the cost of equity has increased since the
11 conclusion of Avista's last general rate case. Difficult economic conditions and increased
12 volatility in the financial markets have caused a flight to quality among investors, meaning that
13 they have a preference for investments with very low risk, such as U.S. Treasury bonds, and they
14 are demanding a higher premium (return) for taking additional risk. As explained earlier in my
15 testimony, the interest rate spreads between US Treasuries and utility bonds increased
16 dramatically in the later part of 2008. Equity investments inherently contain more risk, and our
17 cost of equity has also increased since our last rate case.
18 The Company is proposing an 11.0% return on common equity (ROE), which falls below
19 the lower end of Dr. Avera's recommended range of required return on equity. Dr. Avera
20 testifies to analyses related to the cost of common equity with an ROE range of 11.3% to 13.3%.
21 In his testimony Dr. Avera states that:

1 Considering investors' expectations for capital markets and the need to
2 support financial integrity and fund crucial capital investment even
3 under adverse circumstances, I concluded that Avista's requested ROE
4 of 11.0% percent is reasonable. (P. 5, L's. 6-9)
5
6 **Q. Dr. Avera suggests an ROE range of 11.3% to 13.3%. Why is Avista**
7 **requesting an ROE below the lower end of the range?**
8 A. As I have testified, Avista has made solid progress towards improving its financial
9 health. If Avista can earn an 11.0% ROE, I believe our financial condition would continue to
10 improve and would further strengthen the credit ratings ratios.
11 Furthermore, as the Company has worked toward improving its financial condition over
12 the last several years, it has done so with the customer in mind. Avista is attempting to balance
13 the ability to continue to improve our financial health and access capital markets under
14 reasonable terms with the impacts that increased retail rates have on its customers. In this case,
15 although we believe an ROE greater than 11.0% is supported and is warranted, we also believe
16 the 11.0% provides a reasonable balance of the competing objectives.
17 **Q. Please summarize the proposed capital structure and the cost components for**
18 **debt and common equity.**
19 A. As also shown on page 2 of Exhibit No.___(MTT-2), the following illustration
20 shows the capital structure and cost components proposed by the Company.

1 **Illustration No. 6:**

2 **AVISTA CORPORATION**
3 Capital Structure and Overall Rate of Return

4

PRO FORMA Cost of Capital as of December 31, 2009	Amount	Percent of Total Capital	Cost		Component
Total Debt (1)	$1,266,901,042	52.49%	6.57%		3.45%
Common Equity	1,146,750,909	47.51%	**11.00%**	(2)	5.23%
TOTAL	$2,413,651,951	100.00%			**8.68%**

10
(1) Includes short term debt
11 (2) Proposed Return on Common Equity - See Avera testimony

12

13 **VIII. INCREASE IN PENSION EXPENSE**

14 **Q. Has the Company included an adjustment in this filing for increased pension**
15 **expense?**

16 A. Yes. The Company's pension expense has increased, on a system basis, from
17 $12.1 million for the test year ended September 30, 2008 to $22.2 million for 2009. Company
18 witness Ms. Andrews discusses the accounting adjustment to results of operations to reflect this.

19 **Q. What is the reason for the increase in pension expense in 2009?**

20 A. The increase in pension expense is due primarily to the negative overall market
21 performance in 2008. Although the pension plan assets are diversified among investment
22 classes, negative returns were associated with virtually all assets except cash. The stock market

1 had a negative 38% return on the S&P 500 Index, and bond markets and commodities also
2 performed negatively in 2008.
3 The Company's 2008 pension plan return on assets is estimated to be negative 21%. The
4 negative returns and resulting declining value of our pension plan assets increased the pension
5 expense for 2009.
6 The overall market decline impacted the pension plan assets of other companies as well.
7 Most companies with defined benefit pension plans have experienced similar asset value declines
8 and increased funding levels as a result of general market conditions and the Pension Protection
9 Act of 2006 (PPA).
10 Results from an EEI survey conducted in early December 2008, indicated that all 24
11 electric utilities who participated in the survey were estimating negative returns for their pension
12 plan assets in 2008. The 2008 average expected pension returns of the 24 companies surveyed
13 was a negative 26.7%. The Company's pension returns, as described above, were somewhat
14 better than these reported returns.
15 **Q. Will you describe the process utilized by the Company for administering**
16 **investments in its defined benefit plan (pension plan)?**
17 A. Yes. The Company has a very disciplined approach to the oversight and
18 monitoring of the pension plan. The Board of Directors of the Company, acting through the
19 Finance Committee of the Board, is responsible for setting, monitoring and adjusting the
20 Investment Policy Statement (IPS) with respect to the investment of funds for the pension plan.
21 The IPS summarizes the Finance Committee's investment policies for the management and
22 oversight of the pension plan. It sets forth the objectives of the plan, the strategies designed to

1 achieve these objectives, procedures for monitoring and control of plan assets and the delegation
2 of responsibilities for the oversight and management of plan assets. Given the long-term time
3 horizon of the pension plan, the IPS is designed to endure multiple market environments and to
4 not be reactive to what might be considered normal short-term events. The IPS includes a policy
5 portfolio that envisions a reasonably stable allocation of assets among major asset classes.

6 **Q. What are the investment policies for management and oversight of the**
7 **pension plan?**

8 A. As stated in the IPS, the objectives of the pension plan are designed to provide a
9 total return that, over the long term, provides sufficient assets to fund its liabilities subject to an
10 acceptable level of risk, contributions and pension expense deemed appropriate by the Board
11 Finance Committee and to diversify investments within asset classes to reduce the impact of
12 losses in single investments.

13 **Q. What resources does the Company utilize to perform its duties under the**
14 **Investment Policy Statement related to investment of Pension Assets?**

15 A. The Company retains an external investment management consultant to develop
16 and recommend asset allocation of the pension plan assets, evaluate and recommend investment
17 managers and monitor the performance and business of the investment managers of the plan
18 assets. This consultant provides a quarterly performance and compliance report of the plan
19 assets. The performance report is reviewed by the Company's internal Benefits Plan
20 Administration Committee quarterly. The performance report is also reviewed by the Board
21 Finance Committee on a quarterly basis. In addition, a report detailing compliance with the
22 specific requirements of the IPS is provided quarterly to the Board Finance Committee.

1 **Q. What are the impacts of the Pension Protection Act (PPA) on the Company's**
2 **Pension plan?**
3 A. The PPA was passed in 2006 and requires annual increases to the pension funding
4 level in order to eventually achieve a fully funded plan. The PPA established that in 2008 the
5 funding level would be 92% of the pension plan obligations. For 2009 this level increases to
6 94%. In 2008, Avista's funding level was 92% and is projected to be 94% in 2009, based on
7 increased Company contributions to the plan. If the plan funding level does not meet these
8 established percentages, the entire funding deficit must be added to the contribution over the next
9 seven years in order to be fully funded after seven years. If the percentage falls below 80%, plan
10 restrictions would be imposed and the plan would be considered "at-risk." Should this occur,
11 benefit accruals would be frozen and plan participants would not be able to accrue additional
12 pension benefits. Additionally, lump sum distributions to participants would not be allowed.
13 To avoid these restrictions the Company is committed to fully meeting these funding
14 levels and complying with the requirements of the PPA.
15 **Q. Do the annual cash contributions to the pension fund equal the annual**
16 **pension expense recognized by the Company?**
17 A. No. In fact the cash contribution that Avista will make to the pension fund in
18 2009 will be substantially higher than the proforma expense of $22.2 million identified earlier.
19 The annual cash contribution is driven by the need to comply with the funding requirements of
20 the PPA (e.g., 94% funded by the end of 2009). It will be necessary to make a cash contribution
21 to the pension fund in 2009 of at least $42 million, and more recent analysis indicates that we
22 may need to contribute $67 million of cash in 2009.

1 The pension expense recognized by the Company is determined using a formula as
2 prescribed by Financial Accounting Standard No. 87 (FAS 87). The objective of FAS 87 is to
3 recognize the compensation cost of an employee's pension benefits (including prior service cost)
4 over that employee's approximate service period. While the pension cash contribution amount
5 does affect the pension expense, the FAS 87 assumptions and calculations are different from
6 those used to determine the funded status.

7 As can be seen by the differences in the 2009 cash contribution of $67 million and the
8 pension expense of $22.2 million, the differing requirements of the PPA and FAS 87 can result
9 in a substantial difference between cash contributions and recognition of expense. The current
10 level of pension expense reflected for ratemaking purposes is $11.85 million. Therefore, until
11 the conclusion of this case, the current annualized difference between the cash contribution and
12 pension expense is over $55 million ($67 million - $11.85 million).

13 **Q. What impact does that timing difference have on the Company?**

14 A. The result for Avista in 2009 is that the Company would make a cash payment of
15 $67 million, while recovering $11.85 million of expense through its retail rates. Absent some
16 form of accounting treatment or other relief from the Commission, Avista would not recover the
17 time value of money on the difference between the cash payment and the level of expense.
18 Because of the magnitude of this difference, the absence of a carrying cost would have a
19 significant impact on the earnings of the Company. The difference of $55 million times the
20 requested rate of return of 8.68% is $4.8 million annually.

21 **Q. Have you seen these kinds of cash versus expense differences in the past?**

1 A. Nothing even close to this magnitude. A comparison of cash payments versus
2 pension expense for each year from 1992 through 2008 is shown in Illustration No. 7 below. Not
3 only are the annual differences much smaller, but on a cumulative basis through 2007, the
4 difference is only $1.4 million. However, in 2008 the cash payment is $16.0 million higher than
5 the expense, and the difference for 2009 will be even greater.

6 **Illustration No. 7:**

Year	Cash Contribution	Annual Expense	Difference	Cumulative Difference
1992	$0.0	-$1.1	$1.1	$1.1
1993	$0.0	-$0.5	$0.5	$1.6
1994	$0.0	$1.0	-$1.0	$0.6
1995	$0.0	$2.0	-$2.0	-$1.4
1996	$0.0	$2.4	-$2.4	-$3.8
1997	$3.3	$2.2	$1.1	-$2.7
1998	$0.0	$1.5	-$1.5	-$4.2
1999	$0.0	$2.4	-$2.4	-$6.6
2000	$3.3	$0.8	$2.5	-$4.1
2001	$0.0	$3.8	-$3.8	-$7.9
2002	$12.0	$9.3	$2.7	-$5.2
2003	$12.0	$14.9	-$2.9	-$8.1
2004	$15.0	$13.6	$1.4	-$6.7
2005	$15.0	$11.9	$3.1	-$3.5
2006	$15.0	$12.8	$2.2	-$1.3
2007	$15.0	$12.3	$2.7	$1.4
2008	$28.0	$12.0	$16.0	$17.3

7

8 **Q. Do you expect these major cash versus expense differences to continue for the**
9 **indefinite future?**
10 A. No. Although they may continue for some period of time, as the financial markets
11 recover, which we anticipate they will at some point, the cash contribution requirement for the

1 pension plan will come down and potentially go to zero at some point. At that point, there would
2 be opportunity for the cumulative difference between cash and expense to again move toward
3 zero.

4 In the meantime, however, we have a significant difference between the cash contribution
5 and pension expense that needs to be addressed in some way.

6 **Q. What is the Company proposing with regard to this difference between the**
7 **cash contribution to fund the pension plan and the annual level of pension expense?**

8 A. Due to the substantial difference between the 2009 pension payment and the
9 amount of authorized utility pension cost, the Company is requesting approval to establish a
10 regulatory asset for the carrying costs on the cumulative difference between payments and
11 authorized pension cost. It is important to emphasize that we are not requesting accounting
12 treatment to defer the actual dollar differences between the cash payment and expense, but only
13 the carrying cost on those dollar differences.

14 In future periods if the pension cash payments are less than the authorized cost, the
15 cumulative difference will decrease and the resulting carrying cost accrual will decrease.

16 **Q. When does the Company propose to start the accrual of the carrying cost,**
17 **and at what rate?**

18 A. The Company is proposing to begin accruing the carrying charge effective
19 February 1, 2009, at its authorized rate of return during the month the accrual occurs,
20 compounded annually. The current authorized rate of return is 8.43%.

21 **Q. How would the accrual calculations be made?**

1 A. A reduction to the cash payments would first be made to remove the portion
2 related to non-utility. The remaining utility portion would be allocated to utility jurisdictions and
3 services based on the labor dollars included in this filing.

4 Assuming the Company will be making contributions to the pension plan in 2009 of $67
5 million, after removing the portion of pension costs related to non-utility companies of 0.42%, or
6 $0.28 million, the remaining portion of the $67 million related to utility operations amounts to
7 $66.72 million. In contrast, the amount of pension expense related to utility operations on a
8 system basis is $11.85 million from the last general rate case.

9 A carrying charge would be accrued each month, beginning February 1, 2009, based on
10 the cumulative difference between the actual cash payments and the authorized pension expense.

11 **Q. What accounts would be used to account for the accrual of the carrying cost?**

12 A. The accrual of the carrying cost would be recorded by debiting Account 182.3 –
13 Other Regulatory Assets and crediting Account 419 – Interest Income. The carrying cost
14 calculation and a breakdown of the regulatory asset would be maintained by utility jurisdiction
15 (Washington and Idaho) and utility service (electric and gas). Should the accrual become
16 negative, Account 431 – Other Interest Expense would be debited and Account 182.3 would be
17 credited until the balance in Account 182.3 reaches zero, and then, Account 254 – Other
18 Regulatory Liabilities would be credited. Deferred federal income taxes would be recorded by
19 debiting Account 410.2 – Provision for Deferred Income Taxes, Other Income and Deductions
20 and crediting Account 283 – Accumulated Deferred Income Taxes–Other.

21 **Q. How would the deferred carrying costs be recovered in rates?**

1 A. The Company would continue to review the balance of deferred carrying costs to
2 determine if a rate adjustment to recover the costs was necessary. The regulatory asset/regulatory
3 liability accounts will function like a balancing account. While a regulatory asset will be created
4 in 2009, a rebound in the investment market could cause the regulatory asset to be offset by
5 regulatory liability entries over a period of time, and no rate adjustment would be necessary. If a
6 rate adjustment were to become necessary, the Company would file a request as part of a general
7 rate case or other filing to recover the deferral balance.

8 **Q. Does that conclude your pre-filed direct testimony?**

9 A. Yes.