BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-170485

DOCKET NO. UG-170486

REBUTTAL TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

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

6 **Q. Are you the same Mark T. Thies who filed pre-filed direct testimony, on behalf**
7 **of Avista Corporation ("Avista" or "Company")?**

8 A. Yes, I am. I filed direct testimony, Exh. MTT-1T, and Exh. MTT-2 through Exh.
9 MTT-5.

10 **Q. Please summarize the purpose of your rebuttal testimony.**

11 A. This rebuttal testimony responds to the direct testimony of each of the witnesses for:

12 • Staff of the Washington Utilities and Transportation Commission ("Staff") witnesses Mr.
13 McGuire (Exh. CRM-1T) and Mr. Parcell (Exh. DCP-1T);
14
15 • Industrial Customers of Northwest Utilities ("ICNU") witness Mr. Gorman (Exh. MPG-
16 1T);
17
18 • Joint ICNU and Northwest Industrial Gas Users ("NWIGU") witness Mr. Mullins, (Exh.
19 BGM-1T);
20
21 • Public Counsel witnesses Mr. David Garrett (Exh. DJG-1T) and Mr. Mark Garrett (Exh.
22 MEG-1T).
23

24 In my testimony, I will respond to those witnesses with respect to:

25 (i) The continued need for capital expenditures;
26 (ii) The Company's recent earned returns;
27 (iii) Cost of Capital and Capital Structure;
28 (iv) Interest rate hedging; and

1 (v) Impact of Hydro One Merger and Proposed Tax Reform.

2

3 This rebuttal testimony, coupled with the rebuttal testimony of Company witness Mr. McKenzie,
4 demonstrates that the Commission should accept the Company's filed capital structure and rate of
5 return, and reject the capital structure and rate of return proposed by witnesses for Staff,
6 ICNU/NWIGU, and Public Counsel. In brief, I will provide information that shows:

7-9
- The Company has followed its capital budgeting processes to establish an appropriate capital spending level that balances both the risks and consequences of not investing into the system.

10

11-13
- A 50% common equity ratio is appropriate, consistent with the Commission's ability to set a capital structure that can be hypothetical, and provides a reasonable balance between safety and economy.

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15-16
- The cost of debt as filed at 5.62% is the most appropriate cost of debt that should be used for the rate effective period beginning May 1, 2018.

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18-20
- The Company developed and followed an Interest Rate Risk Management Plan which we believe manages risk and reduces interest rate variability on the customer's behalf.

21

22-24
- The pending merger with Hydro One will be properly and comprehensively addressed in the separate merger application and it would serve no useful purpose to try and incorporate aspects of that separate filing into this general rate case.

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26-27
- Without appropriate rate relief, the Company will severely underearn the authorized return on equity and suffer financial harm.

28

29 **Q. Are you sponsoring any exhibits that accompany your testimony?**

30 A. Yes. I am sponsoring Exh. MTT-7, which is a copy of a July 30, 2013 presentation
31 related to Interest Rate Hedging given by Avista to Staff. I am also sponsoring Exh. MTT-8 which is
32 a copy of Avista's Internal Audit Department's review of Avista's interest rate management plan. A
33 table of contents for my testimony is as follows:

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10 **II. CAPITAL EXPENDITURES**

11 **Q. Staff witness Ms. Scanlan proposed in her testimony a level of capital that is**
12 **substantially below that included in the Company's original case.[1] What is the Company's**
13 **response?**

14 A. As discussed in the Company's direct case, as well as in the rebuttal testimonies of
15 Company witnesses Mr. Morris, Ms. Andrews, Ms. Schuh, and others, the level of rate base proposed
16 to be recovered in customer's rates is appropriate. However, in an effort to "strike-a-balance"
17 between Staff and the Company's position, Ms. Andrews and Ms. Schuh propose, on rebuttal, a lesser
18 level of capital that should be included in customer's rates than was originally proposed.

19 **Q. Please respond to ICNU/NWIGU witness Mr. Mullins' assertions that Avista's**
20 **capital needs are actually expected to decrease?[2]**

21 A. Mr. Mullins states that, "my expectation has been that Avista's level of capital
22 expenditures will begin to slow in the future."[3] That expectation is just not reality for Avista.

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[1] See generally Exh. KBS-1T, Table 1 and 2, pp. 20-21
[2] Exh. BGM-1T, p. 24, ll.12-17
[3] Id. ll. 12-13

1 **Q. What are Avista's recent and planned capital expenditure levels?**

2 A. Avista's plans call for a continuation of utility capital investments in generation,
3 transmission and distribution systems to preserve and enhance service reliability for our customers.
4 Capital expenditures of approximately $2 billion are planned for the five-year period ending
5 December 31, 2021 ($405 million annually). Illustration No. 1 below summarizes the capital
6 expenditure levels for recent years, as well as planned expenditures through 2021.

7 **Illustration No. 1: Capital Expenditures**

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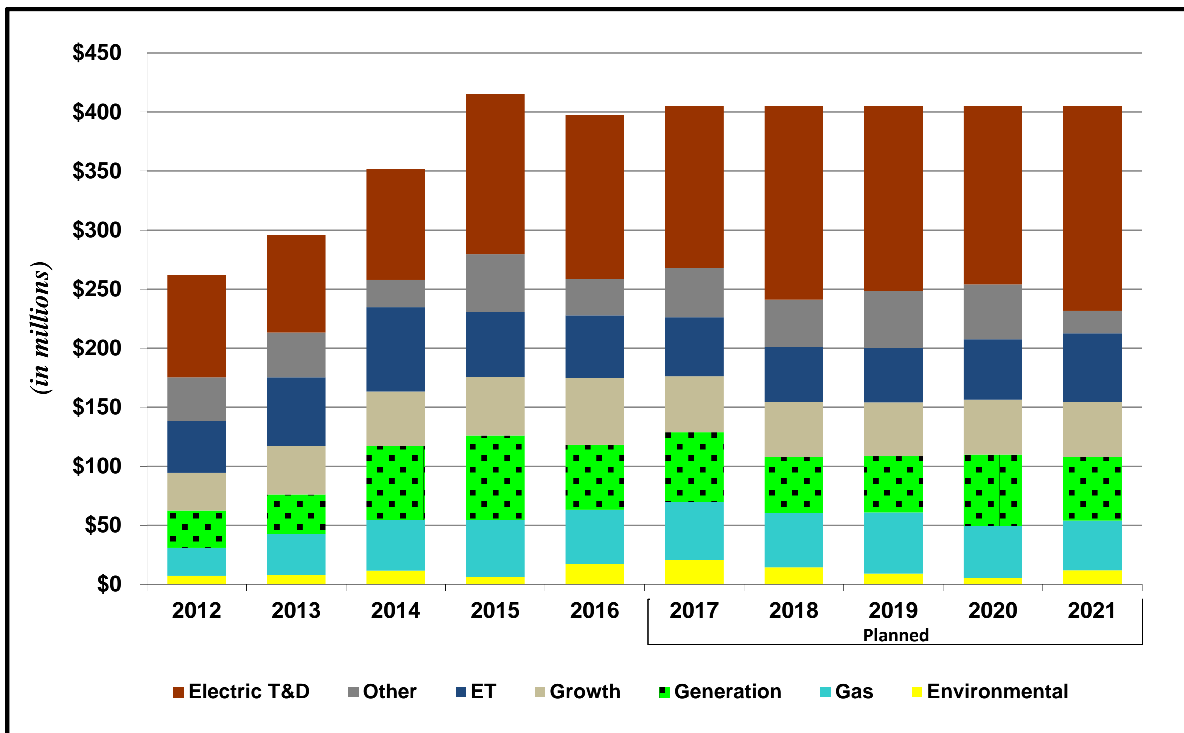

18
19 ** The higher level of capital expenditure in 2015 was driven by storm costs for the November windstorm, and costs related to a renegotiation of the Coyote Springs Long Term Service Agreement, which occurred late in the year.*

1 **Q. What is the basis for the Company's planned level of capital expenditures?**

2 A. As discussed in my direct testimony, the level of capital investment in recent years has
3 been driven primarily by the business need to fund a greater portion of the departmental requests for
4 new capital investments that, in the past, were unfunded. The Company's practice has been to
5 constrain the level of capital investment each year, such that not all of the prioritized projects and
6 programs[4] will be funded in a given year at the level requested. Avista believes that holding capital
7 spending below the level requested accomplishes several important objectives, including:

8-10
- ***Promotes Innovation*** - Encourages ways to satisfy the identified investment needs in a manner that may identify potential cost savings, defer implementation, or other creative options or solutions.

11-12
- ***Balances Cost and Risk*** – Captures the customer benefits of deferring needed investments by prudently managing the cost consequences and risks associated with such deferrals.

13-14
- ***Efficiently Allocates Capital*** – Ensures that the highest-priority needs are adequately funded in the most efficient and effective way.

15-17
- ***Reduces Variability*** - Moderates the magnitude of year-to-year variability to avoid excessive rate impacts, and more efficiently optimizes the number and cost of personnel necessary to carry out the capital projects.

18
19 Avista's capital investments originate from the following six major "investment drivers":

20-25
1. Respond to customer requests for new service or service enhancements;
2. Meet our customers' expectations for quality and reliability of service;
3. Meet regulatory and other mandatory obligations;
4. Address system performance and capacity issues;
5. Replace infrastructure at the end of its useful life based on asset condition; and
6. Replace equipment that is damaged or fails, and support field operations.

26

27 Avista currently has chosen to stabilize the level of annual capital spending at what can be
28 described as a constrained level of $405 million, in an effort to accomplish the objectives described
29 above. In fact, the dollar amount of capital projects requested by departments with the amounts

[4] "Project" refers to an individual investment for a specific period of time. "Programs" represent investments that address systemic needs that are ongoing with no recognized endpoint, such as the wood pole management program. For ease of reference, the term "capital project" will be used to represent both capital projects and capital programs.

approved by the Company is provided in Table No. 1 below. The dollar amounts for projects that were delayed (not approved) are also shown:

Table No. 1: Capital Project Requests/Approvals ($ millions)

Year	Requested	Approved	Delayed	% Capital Delayed
2012	$269	$250	$19	8%
2013	$320	$250	$70	28%
2014	$386	$331	$55	17%
2015	$404	$355	$49	14%
2016	$451	$375	$76	20%
2017	$461	$405	$56	14%
2018	$455	$405	$50	12%
2019	$531	$405	$126	31%
2020	$556	$405	$151	37%

In the end, the constrained level of capital spend will not otherwise materially cause Avista to reduce its capital expenditures in the future, as the need is real.

III. RECENT EARNED RETURNS

Q. Does Avista's recent earnings show that Avista is far from needing any sort of rate relief, as suggested by Mr. Mullins' testimony?[5]

A. No. As I will discuss below, the Company expects to under-earn for 2017 as a result of the Company not receiving additional rate relief in 2017. Avista's historical earned returns on equity ("ROE") for the periods 2013-2016 confirm that the revenue increases granted by the Commission, when the Commission utilized certain regulatory methods to address regulatory lag in

[5] Exh. BGM-IT, p. 6-7

1 each of those years, resulted in earned returns very close to Commission-authorized ROEs.
2 Additionally, costs continue to rise in 2017, as the Company continues to invest the necessary and
3 appropriate capital to maintain a safe and reliable system.

4 **Q. Is the Company using actual earned returns or normalized returns in this**
5 **discussion?**

6 A. In this discussion, the Company is utilizing <u>normalized</u> returns, or commission basis
7 returns, when discussing ROEs. Actual earned returns are affected by factors such as the impact of
8 varying hydro-electric generation on power supply costs (that fall within the deadband of the Energy
9 Recovery Mechanism), etc. These types of abnormal conditions are "normalized out" for ratemaking
10 and provide an after-the-fact, "apples-to-apples" comparison with the ROE authorized by the
11 Commission for the respective periods.

12 **Q. What were Avista's normalized historical ROE when a traditional approach, as**
13 **suggested by Mr. Mullins, is utilized?**

14 A. Prior to 2013, and prior to the Commission factoring in attrition experienced by
15 Avista, the Washington jurisdiction earned returns for Avista's utility operations were well below
16 that authorized by the Commission in those years. It represented "chronic under-earning" under any
17 reasonable definition. Illustration No. 2 below shows Avista's earned Commission Basis Returns for
18 its Washington jurisdiction for the period 2008-2014.

19 Illustration No. 2 below shows that prior to 2013 (2008-2012), when the Modified Historical
20 Test Year (Pro Forma) Study was used to set rates, the Company consistently under-earned by
21 approximately 200 basis points on a normalized ROE basis.

1 **Illustration No. 2:**

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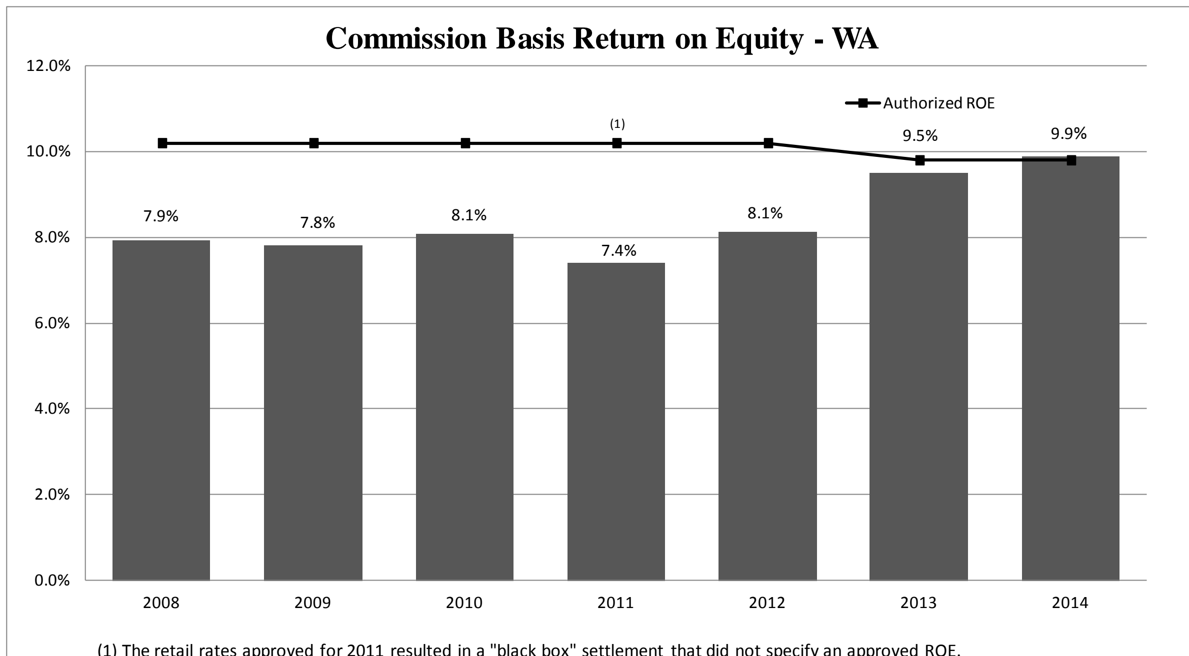

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12 **Q. What were Avista's normalized historical ROEs when other regulatory methods,**
13 **such as attrition, were used?**

14 A. Starting in 2013, once the consideration of "attrition" was included in Avista's
15 authorized rate relief, the Company began to earn at or close to its allowed returns as shown in
16 Illustration No. 2 above.[6]

17

[6] In Order No. 06 (Docket UE-160228 and UG-160229) the Commission noted its understanding that the proposed settlements impacting the 2013-2014 rate periods relied upon attrition adjustments: "Despite the settlement's disavowal of express reliance on the Company's or Staff's attrition adjustments, the Commission made clear in Order No. 09/14 its understanding that Staff and Avista relied heavily on the existence of attrition to justify both the 2013 and 2014 rate increases proposed in the settlement. (See paragraph 34 of Order No. 06.) For 2015, at paragraph 41: "Order No. 05 [of Dockets UE-140188 and UG-140189] discusses that Avista claimed in its as-filed case to be experiencing attrition and included in its pre-filed evidence an attrition study, which the Company used to derive its revenue deficiency. Staff adopted a similar trending method to identify projected expense levels, which Staff proposed the Commission use to set rates."

1 For the period 2013 forward, these earnings by the Company do not militate against the use of
2 regulatory adjustments; instead, they point to the fact that the use of a regulatory adjustment (an
3 "attrition allowance" in those cases) in determining the Company's rate relief approved for 2013-2016
4 allowed the Company a better opportunity to earn at or close to its authorized returns. Said another
5 way, attrition is precisely the regulatory adjustment that made it possible for the Company to actually
6 earn at or close to its allowed returns, rather than continue to chronically under-earn as it had prior to
7 2013.
8 **Q. Turning now to 2017, what was the expected impact of receiving no rate relief on**
9 **January 1, 2017?**[7]
10 A. The Company expected we would significantly under-earn in 2017 for our Washington
11 jurisdiction.
12 **Q. Where does the Company now expect its electric 2017 normalized ROE to be?**
13 A. The Company expects to earn a normalized ROE of 8.8% for its Washington electric
14 operations. Compared to an allowed ROE of 9.5%, the Company expects to under-earn by 70 basis
15 points.
16 **Q. With regard to Avista's expected normalized return on equity of 8.8% for its**
17 **electric operations, what has occurred during the year that caused the return to be better than**
18 **originally expected?**
19 A. There were several unanticipated items that occurred in 2017 which are contributing
20 to better earnings this year. Examples of some unusual and unexpected items include reductions in
21 pension and medical expenses, credit and collection expenses, and software licensing expenses.

[7] Order No. 06 Docket Nos. UE-160228 and UG-160229

1 Pension expenses unexpectedly decreased due to changes in asset allocation and favorable returns on
2 the fund balance. The Company has a self-insured medical plan. Claims under the plan for 2017 have
3 been coming in lower than projected which has resulted in lower medical expenses. The accrual for
4 bad debt expenses (write-offs of delinquent customer accounts) decreased during the year because of
5 process improvements in the credit and collections processes. The Company planned to incur certain
6 software licensing expenses in 2017, but that did not occur due to the timing of certain information
7 technology projects. These unexpected decreases also affected natural gas operations.
8 The Company still expects to under-earn on a combined electric and natural gas basis and
9 absent the unexpected and unusual decreases in costs, the Company would be significantly under-
10 earning.
11 **Q. Are 2017 expected earnings or prior year actual results relevant to Year 1 of the**
12 **Company's Three-Year Rate Plan?**
13 A. No. This general rate case filing is based on an initial rate year from May 1, 2018
14 through April 30, 2019.[8] Costs continue to rise from 2017 through the initial rate year. Additionally,
15 the Company continues to invest the necessary and appropriate capital to maintain a safe and reliable
16 system. Further deterioration of earnings will occur absent the requested amount of rate relief in our
17 rebuttal case. As Ms. Andrews demonstrates, absent rate relief, the Company will not have a
18 reasonable opportunity to earn its allowed rate of return in Year 1 of the Three-Year Rate Plan. As
19 Ms. Andrews shows in Exh. EMA-10T (footnote 7), absent rate relief in this case, the rates of return
20 for Rate Year 1 (May 1, 2018 – April 30, 2019) would be 5.61% (electric) and 6.47% (natural gas).

[8] Where appropriate, the cost reductions in 2017 noted above have been reflected in the Company's costs in this case.

1 **Q. Is the Company continuing to support an earnings test for the Three-Year Rate**
2 **Plan?**
3 A. Yes. The Company has proposed some "checks and balances" to ensure that retail
4 rates for the duration of the multi-year rate plan are fair for customers. Through the existing one-way
5 earnings tests for each of its Washington electric and natural gas operations, if Avista were to over-
6 earn during the Three-Year Rate Plan, Avista would share half of the overearnings, protecting
7 customers. Staff witness Mr. Hancock agrees, stating that the Commission "should maintain the
8 existing earnings sharing program through the multi-year rate plan."[9]
9

10 ## IV. COST OF CAPITAL AND CAPITAL STRUCTURE

11 **Q. Do you agree with the other witnesses' positions regarding cost of capital and**
12 **capital structure?**
13 A. No, we do not agree with the other witnesses' positions, and the discussion that follows
14 will explain why the Commission should reject their positions and accept the Company's proposed
15 cost of capital and capital structure. The witnesses' positions, and Avista's[10] are summarized in the
16 tables below:

[9] Exh. CSH-1Tr, p. 19, ll. 4-5
[10] The calculations of the Company's proposed capital structure, cost of debt and overall cost of capital are provided with Exh. MTT-2.

1 **Table No. 2: Avista's Proposed Cost of Capital**

2

Avista Corporation Proposed Cost of Capital			
	Proposed Structure	Cost	Component Cost
Total Debt	50.0%	5.62%	2.81%
Common Equity	50.0%	9.90%	4.95%
Total	100.0%		**7.76%**

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9 **Table No. 3: Staff's Proposed Cost of Capital**

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Staff - David Parcell (DCP-1T) Proposed Cost of Capital			
	Proposed Structure	Cost	Component Cost
Short Term Debt	2.9%	3.26%	0.09%
Long Term Debt	48.6%	5.54%	2.69%
Common Equity	48.5%	9.10%	4.41%
Total	100.0%		**7.20%**

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17 **Table No. 4: ICNU's Proposed Cost of Capital**

ICNU - Michael Gorman (MPG-1T) Proposed Cost of Capital			
	Proposed Structure	Cost	Component Cost
Short Term Debt	2.9%	3.26%	0.09%
Long Term Debt	48.7%	5.31%	2.59%
Common Equity	48.4%	9.10%	4.40%
Total	100.0%		**7.09%**

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1 **Table No. 5: Public Counsel's Proposed Cost of Capital**

Public Counsel - David Garrett (DJG-1T) Proposed Cost of Capital			
	Proposed Structure	Cost	Component Cost
Total Debt	51.5%	5.62%	2.89%
Common Equity	48.5%	9.00%	4.37%
Total	100.0%		**7.26%**

8 **Q. What is the reason for the difference between the Company's requested capital**
9 **structure and the capital structures proposed by Mr. Parcell, Mr. Gorman, and Mr. D. Garrett?**
10 A. The primary difference between the Company's proposed capital structure of 50%
11 equity and 50% long term debt and Mr. Parcell, Mr. Gorman and Mr. D. Garrett's proposed capital
12 structure is their inclusion of short-term debt in the calculation. Table No. 5 above indicates that Mr.
13 D. Garrett did not include short-term debt. However, his testimony and Table No. 5 above has short-
14 term debt included in the long-term debt line item.
15 **Q. Why did Avista propose to exclude short-term debt from the capital structure**
16 **calculation in this case?**
17 A. As explained by Mr. Morris and Ms. Andrews in their direct testimony, the results
18 from the Traditional Pro Forma Study will not yield the electric and natural gas rate relief necessary
19 to provide the Company the opportunity to earn the proposed rate of return requested in this case.
20 One of the rate making "tools" identified by this Commission that can be used to arrive at an end

1 result that provides sufficient revenues is the use of an adjusted capital structure.[11] Both Idaho and
2 Oregon currently use this ratemaking tool of adjusting the capital structure by excluding short-term
3 debt from the capital structure calculation.[12] Avista's currently approved capital structure in Idaho
4 and Oregon includes 50% equity and 50% debt. In this case Avista is proposing a similar adjustment
5 to its capital structure, excluding short-term debt from the capital structure calculation.

6 **Q. Why is the Company maintaining an equity ratio at this level?**

7 A. Maintaining a 50% common equity ratio, excluding short-term debt, has several
8 benefits for customers. We are dependent on raising funds in capital markets throughout all business
9 cycles. These cycles include times of contraction and expansion. A solid financial profile will assist
10 us in accessing debt capital markets on reasonable terms in both favorable financial markets and when
11 there are disruptions in the financial markets. Additionally, this common equity ratio solidifies our
12 current credit ratings and moves us closer to our long-term goal of having a corporate credit rating of
13 BBB+. A rating of BBB+ would be consistent with the natural gas and electric industry average. We
14 rely on credit ratings in order to access capital markets on reasonable terms. Moving further away
15 from non-investment grade (BB+) provides more stability for the Company, which is also beneficial
16 for customers. We believe the proposed 50% equity appropriately balances safety and economy for
17 customers.

18 **Q. What is the reason for the differences between the Company's requested cost of**
19 **long-term debt of 5.76% and Mr. Parcell's proposed 5.54% cost of long-term debt?**

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[11] The WUTC acknowledged in Order No. 08 of Docket No. UE-111048 and UG-111049 of Puget Sound Energy's proceeding, the consideration of adjustments to rate base beyond the historical test period by stating they were open to considering "Use of plant accounts (rate base) measured at the end, or subsequent to the end of the test-year rather than the test-year average," and their openness to consider <u>an "upward adjustment to the equity share in the capital structure</u>." (emphasis added)

[12] Both Idaho and Oregon exclude short-term debt from both the capital structure and the cost of debt.

1 A. Mr. Parcell uses a 5.54% cost of long-term debt based on the recommendation of Staff
2 witness Mr. McGuire which excludes the effects of the 2016 settled interest rate swaps in the
3 calculation of cost of debt. Other than the treatment of the 2016 settled interest rate swaps, Mr.
4 Parcell's proposed cost of debt is no different than the Company's. For reasons discussed later in my
5 testimony, the Company does not agree with the exclusion of the 2016 settled interest rate swaps
6 from the cost of debt.

7 **Q. What is the reason for the differences between the Company's requested cost of**
8 **long-term debt of 5.76% and Mr. Gorman's proposed 5.31% cost of long-term debt?**

9 A. Mr. Gorman proposes a long-term cost of debt of 5.31% which he calculates by
10 assuming an estimated refinancing rate for debt that will mature in mid-2018.

11 **Q. Are Mr. Gorman's adjustments to long-term debt appropriate?**

12 A. No, it is inappropriate for Mr. Gorman to use 2018 pro-forma debt, as the changes in
13 debt costs he is proposing occur in mid-2018 and include forecasted debt issuances. This is entirely
14 inconsistent with how all of the Parties have limited the amount of capital additions (2016 for the
15 most part) that this debt (issued in 2018) is being used to finance. Based on the Commission's
16 methodology and past practice, Mr. Gorman's proposed cost of debt should be rejected as it includes
17 items in the actual rate year that that the Commission should not selectively include if it also does not
18 include the capital the debt, in part, is used to finance.

19 **Q. Please respond to Public Counsel witness Mr. Michael Garret's proposal that**
20 **Avista should move toward a capital structure similar to Hydro One and that it should be used**
21 **for Avista in this case.**

22 A. Mr. Garrett proposes that Avista move toward Hydro One's authorized capital
23 structure of 60% debt and 40% equity, return on equity of 9.19% and a 4.4% cost of debt. He indicates

1 that these metrics are more in line with the downward trend in utility capital costs that he has seen in
2 other jurisdictions across the country. As shown in Mr. McKenzie's testimony, however, Avista's
3 proposed capital structure, return on equity and cost of debt are, in fact, in line with other utilities
4 across the country.

5 **Q. Is Avista continuing to support a proposed ROE of 9.9%?**

6 A. Yes. As Mr. McKenzie reiterates in his Rebuttal Testimony, the proposed 9.9% ROE,
7 together with the proposed equity layer of 50%, would properly balance safety and economy for
8 customers, provide Avista with an opportunity to earn a fair and reasonable return, and provide access
9 to capital markets under reasonable terms and on a sustainable basis.

10

11 **V. <u>INTEREST RATE HEDGING</u>**

12 **Q. As you stated earlier, Mr. McGuire recommends excluding the 2016 settlement**
13 **of interest rate swaps from the Company's filed cost of debt. Do you agree?**

14 A. No. The interest rate swaps were executed in accordance with our Interest Rate Risk
15 Management Plan ("Plan") for the purpose of managing interest rate risk to customers. Mr. McGuire's
16 testimony states that Avista's Plan does not address risk and takes on excessive hedge loss risk and
17 further that Avista's interest rate hedges are not executed for the purpose of managing risk to
18 customers.[13] Both of these statements are unsupported and untrue. My testimony will demonstrate
19 that:

20 • The Company followed the Plan which manages risk and reduces interest rate variability on
21 the customer's behalf;
22

[13] Exh. CRM-1T, pp. 2-3

- The Company reviewed the Plan with the Commission staff and with the Commission in previous rate cases and consistently followed the plan in informing our hedge decisions;

- The plan was reviewed with the Company's Finance Committee of the Board with updates provided at quarterly meetings;

- Mr. McGuire's conclusions about the nature of the Company's Plan and hedge decisions are neither an accurate description of the Plan nor the Company's hedge decisions; and

- Excluding the 2016 interest rate hedges from the cost of debt would be punitive and unjustified.

Q. Why do customers have interest rate risk?

A. Customers have interest rate risk related to ongoing debt issuances to fund capital expenditures and maturing debt. As mentioned earlier in my testimony, the Company is forecasting $2 billion in capital expenditures over the next five years. Additionally, we have $654.5 million of debt maturing during the same period. The need to fund such capital expenditures and maturing debt is ongoing. This results in a significant need for the issuance of long-term debt. We typically issue long-term debt once per year, thus, our concentration exposure to prevailing long-term interest rates occurs all at once rather than across market cycles. This concentration exposure creates interest rate risk, or cash flow volatility related to the future interest payments on the long-term debt.

The overall interest rate on the debt portfolio used to fund utility capital expenditures is a component in our cost of capital. The cost of capital is used to determine a portion of the revenue requirement related to rate base. Thus, the volatility of interest rates presents a substantial risk to utility customers. A significant increase in interest rates can result in a significant increase to a customer's utility bill.

Q. Does addressing interest rate risk benefit customers?

1 A. Yes, reducing interest rate variability reduces variability in customers' rates. To
2 mitigate the impact of interest rate volatility on customers, the Company engages in risk management
3 techniques to hedge financial exposure associated with interest rate uncertainty through the use of
4 interest rate swaps. Interest rate swaps are a tool utilized to lock in a portion of the interest rate in
5 advance of the actual debt issuance. Entering into multiple interest rate swaps over time reduces the
6 concentration risk that is present when pricing debt issuances on a single date.

7 **Q. Is there a benefit to shareholders to hedge interest rate risk?**

8 A. No. Shareholders do not benefit from Avista hedging interest rate risk. The Company
9 implements interest rate risk management activities for the benefit of customers.

10 **Q. Have the Commission and Commission Staff been previously apprised of Avista's**
11 **interest rate hedging activities?**

12 A. The Company has executed interest rate swaps, for purposes of reducing interest rate
13 risk for our customers as early as 2004 and has been fully transparent in communicating its interest
14 rate hedging activities with both the Commission and Staff, as well as other parties to the rate case.
15 The Interest Rate Risk Management Plan has been included as an exhibit to my testimony in every
16 case since it was formalized in 2013, including the current case. The settlement values, either losses
17 or gains, of the interest rate swaps have been clearly included as a component of cost of debt in
18 previous rate cases. In fact, in 2007, the Commission issued an order in Docket No. UE-070311 that
19 addressed the accounting treatment of interest rate hedges, which in part stipulated to amortize the
20 interest rate hedge over the life of debt to be issued:

21 Additionally, the parties recommend that the Commission approve their
22 agreement that the costs of short-term lines of credit may be deferred and
23 amortized over the five year life of the lines of credit, and <u>the costs of</u>
24 <u>interest rate hedges may be deferred and amortized over the life of bonds to</u>

1 be issued upon the maturity of the 9.75% bonds in June of 2008.[14]
2 (emphasis added)
3
4 There have been minor changes made to the interest rate hedging program over time as the
5 Company continually strives to introduce improved methods of addressing interest rate risk and
6 reviews other applicable hedging policies, but the plan remained basically intact and is consistently
7 applied. The Company formalized the Interest Rate Risk Management Plan in 2013 and reviewed
8 the Plan (included as Exh. MTT-7) with Staff (Mr. Ken Elgin and Mr. E.J. Keating) in July 2013[15].
9 **Q. What are the mechanics of the Plan?**
10 A. I will summarize the Plan mechanisms below, but they are discussed in detail in our
11 Interest Rate Risk Management Plan document, which was included as an exhibit to my testimony in
12 this case (Exh. MTT-3C) and every case since it was formalized in 2013.
13 The Plan uses hedge ratios, hedge windows and rate triggers to address interest rate risk for
14 the Company's forecasted debt issuances. Hedge ratios are the proportion of a forecasted debt
15 issuance which is targeted to be hedged. The Company utilizes hedge ratio limits, to manage our
16 hedge loss risk as the unhedged portion of the debt issuance is not subject to hedge loss risk. It is not
17 possible to predict future interest rates, therefore hedge ratio limits help balance interest rate risk
18 (increasing interest rates) with hedge loss risk (decreasing interest rates).
19 Hedge windows are utilized to determine how many hedges to possibly execute prior to
20 issuance of the debt. Hedge windows are determined by dividing the open position (targeted amount
21 of debt to be hedged) by the minimum notional that can be hedged efficiently in the market.

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[14] Order No. 05, Docket No. UE-070311, p. 7
[15] The presentation made to Commission staff in July 2013 was provided as part of Avista's response to Staff Data Request No. 235. Mr. Kevin Christie, Mr. Ryan Krasselt and Mr. Patrick Ehrbar attended for Avista.

1 When a hedge window is established, rate triggers are set by establishing an upper control
2 limit (UCL), a lower control limit (LCL), and a time expiration of a hedge window. The UCL and the
3 LCL are established by calculating the probabilities of the respective swap rate moving higher (UCL)
4 or lower (LCL) than its current rate. These probabilities are determined by calculating a range during
5 a specified time period based on a statistical model incorporating historic interest rate volatility. If a
6 rate trigger for a potential swap transaction is reached (either by reaching a UCL, LCL, or expiration
7 date), the Company solicits at least two market quotes and may transact with the most favorably
8 priced counterparty. The Plan allows discretion for ultimate decision making, and the Company may
9 determine that it is appropriate to take partial action or no action, with respect to executing a hedge.
10 The Company cannot predict, and does not speculate on, the direction or magnitude of future
11 interest rate changes. However, the Company is continually monitoring the interest rate environment
12 and uses the evaluation of the interest rate market conditions, trends, forecasted rates, indicators, and
13 potential drivers of interest rates to inform hedge decisions.
14 **Q. Can you be more specific about some of the factors present in the interest rate**
15 **environment the Company was monitoring as discussed above?**
16 A. Yes. On a daily basis, the Company utilizes Thomson Reuters to monitor interest rates
17 and applicable news or headlines effecting interest rates. Additionally, the Company monitors
18 potential indicators of interest rate changes including economic forecasts and Federal Reserve
19 activity. The Company receives routine updates of interest rate market environments from investment
20 bankers as well.
21 As an example, the chart below was created by the Company based on a Bloomberg News
22 surveys of economists' forecasts of interest rates in March 2013, prior to executing its first hedge for
23 the 2016 debt issuance. This chart shows that the then current rate was 3.1% and the median

1 forecasted interest rate for the US Treasury 30-year bond, the applicable benchmark rate that Avista
2 is hedging, for only a year and a half in the future was expected to be as high as 5%:

3 **Illustration No. 3: March 2013 US Treasury 30-Year Bond Interest Rate Forecast**

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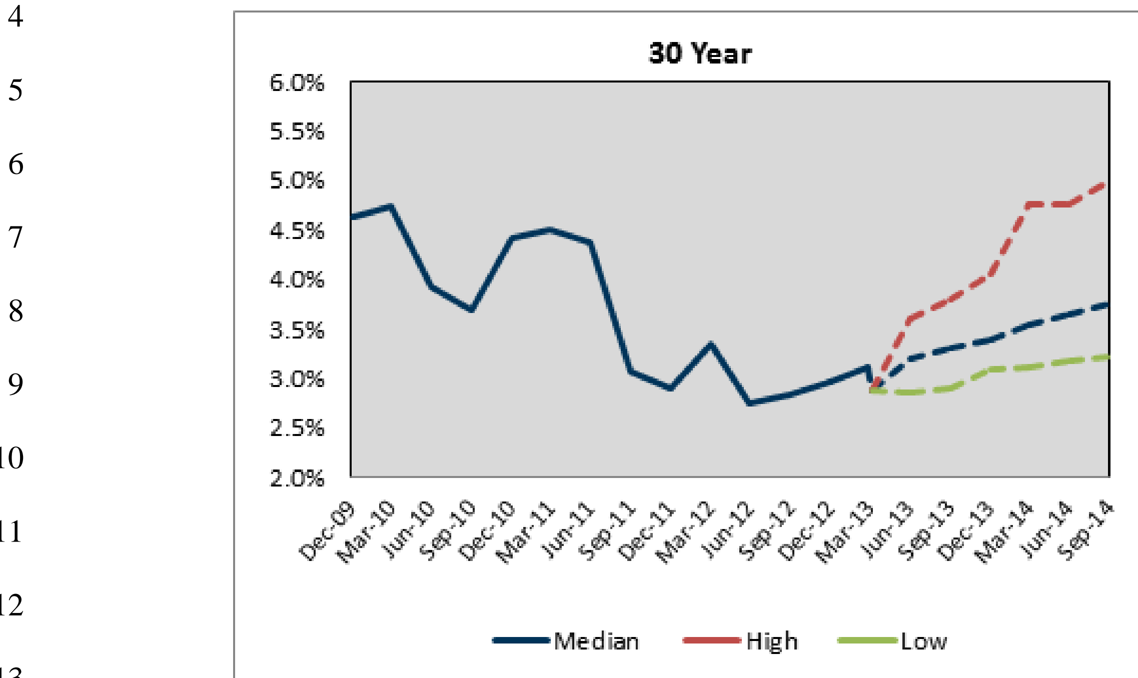

14 **Q. Does the Company hedge interest rate risk similar to how they hedge natural gas**
15 **commodity risk?**

16 A. Yes. The concepts used by the Company in hedging interest rate risk is similar to the
17 concepts for hedging the risks of natural gas commodity costs for local distribution customers. In
18 Docket UG-132019, the Commission issued its "Policy and Interpretive Statement on Local
19 Distribution Companies' Natural Gas Hedging Practices" ("Policy Statement). In that Policy
20 Statement, the Commission discusses the use of hedging to manage customer exposure to market
21 volatility:

22 The rate customers pay for natural gas is directly related to the price a utility pays for
23 natural gas from a supplier. Thus, the volatility of natural gas prices presents
24 substantial risk to the utility and its ratepayers; a sharp increase in the price of natural

> gas supply can result in a sharp increase to a customer's utility bill. To mitigate the impact of market volatility on consumers, LDCs routinely engage in risk management programs. Risk management generally refers to coordinated activities aimed at controlling the impact of adverse events. Because consumers view price increases as adverse events, LDCs managing risk are concerned with controlling the impact of possible price spikes on consumers' bills. Hedging is one risk management tool available to LDCs. [16] (emphasis added and footnotes omitted)

These concepts related to natural gas are similar to what customers face with the cost of debt, in that the volatility of interest rates can result in an increase to a customer's utility bill. Additionally, the mechanics of the interest rate hedging model discussed above are similar to that of the natural gas commodity hedging model.

Q. Has the Commission reviewed the natural gas commodity hedging practices of the Company?

A. Yes. The Commission began a Natural Gas Hedging Investigation in 2012. The investigation was concluded in March 2017 (Docket UG-132019) with the Commission's issuance of the Policy Statement. Avista actively participated in the Natural Gas Hedging workshops and is in the process of parallel testing the concept of "risk responsive" hedging in its Natural Gas Hedging Plan. Additionally, Avista continues to review its Interest Rate Risk Management Plan to determine how the concept of "risk responsive" hedging can best be incorporated into that plan as well. The Company is open to continued dialog on interest rate hedging.

It is important to remember that in the Policy Statement, the Commission set forth a process, beginning with the local distribution companies 2017 Purchased Gas Cost Adjustment filings, to provide a "Preliminary Hedging Plan" as to how they would integrate risk responsive hedging by

[16] Docket No. UG-132019, "Policy and Interpretive Statement on Local Distribution Companies' Natural Gas Hedging Practices." p. 1.

2020 (so called "Full Strategy Implementation"). Our work in this area, as we have informed the Commission as recently as November 16, 2017, is underway, and we believe that it will help to inform changes to the Company's interest rate hedging program as well.

Q. Mr. McGuire states that Avista "operates its hedging practices in a manner inconsistent with Commission Policy".[17] Do you agree with this statement?

A. No. Mr. McGuire's reference is to the Commission's Policy Statement that was issued on March 13, 2017. Avista's Plan and the hedges that were settled in 2016 were in place prior to the adoption of the Commission Policy. The hedges were entered into during the period April 2013 through July 2016.

As demonstrated above, Avista's plan is well designed and utilizes hedge ratios, hedge windows, rate triggers that factor in volatility, and on-going market analysis. Avista in fact had 1) a prudent interest rate risk management plan in place, 2) followed the Plan, 3) made reasonable hedging decisions factoring in changing interest rate environments and 4) appropriately managed interest rate risk for customers.

Q. Have other state commissions reviewed Avista's Plan?

A. Even though other Commissions' decisions are not determinative here in Washington, both Idaho and Oregon have reviewed Avista's Interest Rate Risk Management Plan and have accepted Avista's weighted average cost of debt, including the costs of the 2016 settled interest rate swaps. Mr. Ihle, Oregon Public Utility Commission Staff in Docket No. UG-325 (Avista's most recent 2016 Oregon general rate case), conducted a thorough review of the 2016 interest rate hedges

[17] Exh. CRM-1T, p. 21, ll. 10

1 and concluded that the Company adhered to its operational guidelines and the hedges were effective.

2 He states:[18]

3 Staff stresses that hedge programs should not and generally do not assume that
4 foresight is possible with regard to future values of publicly traded indices, and this is
5 appropriate. Staff does not believe the Company has any special ability to forecast
6 whether interest rates will go up or down in the future. Therefore Staff fully expects
7 that some hedges will ultimately appear favorable and some will appear unfavorable.
8 An unfavorable outcome for a particular hedge in and of itself should not be taken as
9 a sign of an issue or problem with regard to the related hedging program. When
10 examining particular hedges, Staff believes the issues that should be examined are 1)
11 whether the hedges are consistent with an established plan, and 2) whether the hedges
12 were effective. Any analysis beyond this—for example what actions the Company
13 should have expected the Federal Reserve to take with regard to interest rates in the
14 future—is outside what is appropriate for a review of hedges or a hedging program.
15 (emphasis added)
16

17 **Q. Has the Company's Internal Audit department reviewed the Plan?**

18 A. Yes, as part of Internal Audit's 2017 Audit Plan approved by the Audit Committee on

19 February 2, 2017, the Company's Internal Audit department conducted an Interest Rate Risk

20 Management Review with the objective to ensure interest rate derivative transactions entered into

21 were done in accordance with the Company's Interest Rate Risk Management Plan and accurately

22 recorded. Internal Audit concluded:

23 The Interest Rate Risk Management Plan appears to be appropriately documented and
24 there are adequate controls in place to ensure executed interest rate derivative
25 transactions are in compliance with the Interest Rate Risk Management Plan.
26
27 See Exh MTT-8 for a copy of this report.

28 **Q. What are the impacts if the settlement costs for the 2016 debt issuance are**

29 **removed from the cost of debt like Mr. McGuire is recommending?**

[18] OPUC Docket No. UG-325, Staff/1200, p. 12, ll.16 – p. 13, ll. 11

1 A. If the 2016 settled interest rate swap amount of $54 million is removed from the cost of debt, it would not only decrease the Company's long term cost of debt to 5.54%[19], but more importantly it would cause an immediate write-off of approximately $33.6 million in 2018. As the Company has a prudent interest rate hedging plan, *a loss of this magnitude would cause unjustified financial harm to the Company*.

Q. Is Mr. McGuire's demonstration that market volatility was relatively low relevant?[20]

A. No. Mr. McGuire's chart is an after-the-fact calculation of volatility. He does not provide any empirical evidence or analysis that correlates the then current conditions in the market to the future trajectory of interest rates. There is no validation that current or low volatility is a good predictor of the direction or magnitude of changes in interest rates. Said another way, he does not provide analysis that would demonstrate the information available at the time the hedges were executed would have indicated that it was not appropriate to be hedging.

Q. Is it fair to penalize a company for making prudent risk management decisions using the best information available at the time?

A. No. I understand that it is hard to resist the opportunity to use hindsight when viewing current situations. I am sure there are many investors who wish they had purchased Apple stock 10 years ago when it was close to $25 versus its current level of about $170, but that is a hindsight view. Moreover, I would submit that if the hedges had produced a positive result, we would not be having discussions about excluding them from today's revenue requirement calculation.

[19] The total cost of debt, would be 5.41%.
[20] Exh. CRM-1T, p. 15

1 **Q. Have you addressed statements made by Mr. McGuire in his testimony that the**
2 **Company did not address risk and takes on excessive hedge loss risk, and that the Company's**
3 **interest rate hedges are not executed for the purpose of managing risk to customers?**[21]
4 A. Yes. As discussed in describing the mechanics of the Plan, market volatility is utilized
5 in setting the parameters of the Hedge Windows. At the time each interest rate hedge was executed,
6 the information the Company had related to interest rate volatility or trends was historic information.
7 The Company cannot and does not purport to predict interest rates.
8 Mr. McGuire did not accurately describe the Company's Plan or the mechanisms utilized
9 within the Plan. As previously summarized above, the Company's plan manages risk to customers
10 by acknowledging that interest rate risk exists, especially for a utility company that issues debt usually
11 only once a year. The Company hedges a portion of the debt to be issued over a period of time before
12 the debt issuance, thereby not incurring the full risk of pricing debt on a single day. Locking in current
13 prices through hedges over time, is pro-active and reduces concentration risk that is present when
14 pricing debt issuances on a single date.
15 The Company continues to review interest rate risk management alternatives and is open to
16 discussing new options for mitigating customer interest rate risk, similar to methods discussed in the
17 recent natural gas hedging policy; however, excluding the 2016 interest rate hedges from the cost of
18 debt is punitive and unjustified.

[21] Exh. CRM-1T, p. 3, ll. 1-5

1 **VI. IMPACT OF HYDRO ONE MERGER AND PROPOSED TAX REFORM**

2 **Q. Mr. Mark Garrett on behalf of Public Counsel has indicated that it is too early**
3 **to commit to a multi-year rate plan considering both the proposed Hydro One acquisition,[22]**
4 **and a potential for tax reform.[23] Do you agree?**

5 A. No. Regarding the proposed merger with Hydro One, a separate docket has been
6 initiated to address merger related specifics, including future benefits to customers. The proposed
7 transaction is not designed to target the elimination of jobs, or cost cutting that may lead to a
8 deterioration of customer service, customer satisfaction, safety, reliability, or a deterioration of
9 charitable giving, economic development or innovation in the communities Avista serves. There will
10 be some cost savings immediately following the closing of the transaction, such as reduced expenses
11 associated with Avista no longer having publicly traded common stock, fewer non-employee
12 members of the Avista Board of Directors, and other cost savings. These savings, however, will be
13 covered by the proposed Rate Credit. Specifically, Avista and Hydro One are proposing to flow
14 through to Avista's retail customers in Washington, Idaho and Oregon a rate credit of $31.5 million
15 over a 10-year period, beginning at the time the merger closes. Up to $22 million, over the 10-year
16 period, of the total rate credit is offsetable, to the extent Avista demonstrates in a future rate
17 proceeding that costs savings or benefits, directly related to the proposed transaction are already being
18 flowed through to customers. The $31.5 million represents the floor of benefits that will be flowed
19 through to Avista's customers, either through the rate credit or through benefits otherwise included
20 in base retail rates over time. Benefits in excess of the amounts that are offsetable will be flowed
21 through to customers in base retail rate cases as they occur.

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[22] Exh. MEG-1T, p. 16, ll. 14 – p. 17, ll. 10
[23] Exh. MEG-1T, p. 20, ll. 12 – p. 21, ll. 2

1 As for federal tax reform, it makes little to no sense to abandon a multi-year rate plan that 2 would benefit customers, as well as the Company, for tax reform proposals that are currently being 3 developed and are far from being known and measureable. If some form of Tax Reform comes to 4 pass, it will impact all the utilities regulated by the Commission. Of course this is ultimately the 5 Commission's purview, but it is the Company's position that issues that are generic to the Washington 6 utility group should be addressed in a separate generic proceeding, not on a case by case basis. With 7 that said, Avista fully expects that whatever the financial impacts are of potential changes to the 8 federal tax code, they will be addressed in a manner that properly captures those impacts and are 9 properly incorporated in customers rates, even during the Three-Year Rate Plan.

10 **Q. Does this conclude your rebuttal testimony?**

11 A. Yes it does.