Exhibit No. ____ (MKM-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-08________

DOCKET NO. UG-08________

DIRECT TESTIMONY OF

MALYN K. MALQUIST

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 Malyn K. Malquist. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corporation as Executive Vice
6 President and Chief Financial Officer.

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

8 A. I received a Bachelors degree and a Master of Business Administration degree
9 from Brigham Young University. I have also attended a variety of utility finance courses and
10 leadership programs during my 25+ year utility career.

11 I joined Avista in September of 2002 as Senior Vice President. In November 2002 I was
12 named to the additional position of Chief Financial Officer. I was named Executive Vice
13 President in May 2006. Prior to joining Avista, I was General Manager of Truckee Meadows
14 Water Authority in Reno, Nevada, which was separated out from Sierra Pacific Power Company
15 in 2001. I was Chief Executive Officer of Data Engines, Inc., a high tech company located in
16 Reno from June to October of 2000. From April 1994 to April 2000, I was employed by Sierra
17 Pacific Resources, first as the company's Chief Financial Officer and later as its Chairman of the
18 Board and Chief Executive Officer. Following the merger of Sierra Pacific Resources with
19 Nevada Power Company in 1999, I became the President of both Sierra Pacific Power Company
20 and Nevada Power Company. For the sixteen-year period prior to 1994, I was employed by San
21 Diego Gas & Electric Company in various positions, including Treasurer and Vice President –
22 Finance.

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

2 A. I will provide a financial overview of the Company and will explain the overall
3 rate of return proposed by the Company in this filing for its electric and natural gas operations.
4 The proposed rate of return is derived from Avista's costs of debt (including short-term debt,
5 long-term debt and trust preferred securities), and common equity, weighted in proportion to the
6 proposed capital structure.

7 I will address the proposed capital structure and debt cost components. Witness Avera
8 will testify to the appropriate return on equity for the Company.

9 In brief, I will provide information that shows:

10 • Avista's plans call for significant capital expenditure requirements for the utility
11 over the next three to five years to assure reliability in our energy systems, and to
12 keep pace with regional growth and customer demand. Capital expenditures are
13 planned for 2008-2009 of approximately $390 million for customer growth,
14 investment in generation, transmission and distribution facilities for the electric
15 utility business as well as necessary maintenance and replacements of our natural
16 gas utility systems. Avista needs adequate cash flow from operations to fund
17 these requirements.
18
19 • Avista's corporate rating from Standard & Poor's is currently BBB-. Avista
20 Utilities should operate at a level that will support a strong investment grade
21 credit rating, meaning at least a strong "BBB" or weak "A". The Company's
22 financial performance has improved; however, we have not improved financial
23 ratios to a level that would result in a strong investment grade credit rating.
24
25 • The Company has proposed an overall rate of return of 8.43%, including a 46.3%
26 equity ratio and a 10.8% return on equity. We believe the 10.8% provides a
27 reasonable balance of the competing objectives of continuing to improve our
28 financial health, and the impacts that increased rates have on our 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.

1 Certainty of cash flows from operations can only be achieved with the continued support of
2 regulators in allowing the timely recovery of costs and the ability to earn a fair return on
3 investment.

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

5 A. Yes. I am sponsoring Exhibit No. ___(MKM-2) pages 1 through 5, which were
6 prepared under my direction. Avista's credit ratings by the three principal rating agencies are
7 summarized on page 1, and Avista's actual capital structure at December 31, 2007 and pro forma
8 capital structure at December 31, 2008 are included on page 2, with supporting information on
9 pages 3 through 5.

10

11 **II. FINANCIAL OVERVIEW**

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

13 A. The Company has made solid progress in improving its financial health in recent
14 years. The Company has been able to reduce outstanding debt, refinance debt at lower rates and
15 improve cash flows from operations, resulting in improved financial ratios. Additionally, Avista
16 has reduced investments in unregulated subsidiaries and redeployed the majority of the proceeds
17 from the sales of the unregulated subsidiaries to the Utility. The Company has been able to
18 improve its debt ratio and balance the overall debt / equity ratio by paying down debt and issuing
19 additional common stock.

20 Although we have made progress in improving the Company's financial condition, we are
21 still not as strong as we need to be. Avista's goal is to operate at a level that will support a strong
22 credit rating of BBB+ / A-. Operating at this level will help reduce long-term costs to customers.

1 We expect that a continued focus on the regulated utility, conservative financing strategies
2 (including the issuance of common equity) and a continued supportive regulatory environment
3 will contribute to an overall improved financial situation.

4 **Q. What additional steps is the Company taking to improve its financial health**
5 **in the future?**

6 A. We are working to assure we have adequate funds for operations, capital
7 expenditures and debt maturities, through lines of credit with our banks and maintaining
8 adequate access to the capital markets. We have worked with our banks to insure that we have
9 adequate liquidity through the availability of our credit facility on the most economic basis
10 possible. Additionally, the Company plans to obtain a portion of our capital requirements
11 through equity issuance. We also maintain an ongoing dialogue with the rating agencies
12 regarding the measures being taken by the Company to improve our credit rating.

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

17

18 **III. CREDIT RATINGS**

19 **Q. Please explain the credit ratings for Avista's debt and other securities.**

20 A. Rating agencies are independent agencies that assess risks for investors. The three
21 most widely recognized rating agencies are Standard & Poor's (S&P), Moody's Investors Service
22 (Moody's) and FitchRatings (Fitch). These rating agencies assign a credit rating to companies

1 and their securities so investors can more easily understand the risks associated with investing in
2 their debt and preferred stock.

3 Avista's credit ratings by the three principal rating agencies are summarized on page 1 of
4 Exhibit No. ___(MKM-2). Additionally, the following rating actions occurred during 2007 and
5 2008:

6 a. S&P upgraded Avista's corporate credit rating to BBB- from BB+ (February 2008)
7 and Avista's secured debt rating to BBB+ from BBB- (September 2007).
8
9 b. Moody's upgraded Avista's corporate credit rating to Baa3 from Ba1 and Avista's
10 secured rating to Baa2 from Baa3 (December 2007).
11
12 c. Fitch upgraded Avista's long-term issuer default rating to BB+ from BB and its
13 secured debt rating to BBB from BBB- (August 2007 and affirmed in February 2008).
14
15 **Q. Please explain the implications of these ratings (in terms of the Company's**
16 **ability to access financial markets).**

17 A. For each type of investment a potential investor could make, the investor looks at
18 the quality of that investment in terms of the risk they are taking and the priority they would have
19 in the event that the organization experiences severe financial stress. Investment risks include
20 the likelihood that a company will not meet all of its debt obligations in terms of timeliness and
21 amounts owed for principal and interest. Secured debt receives the highest ratings and priority
22 for repayment and, hence, has the lowest relative risk. Thus, lower credit ratings may result in a
23 company having more difficulty accessing financial markets and/or increased financing costs.
24
25

1 **Q. What risks are facing Avista and the utility sector that may have an impact**
2 **on companies' credit ratings?**
3 A. Among the risk factors are the level and volatility of wholesale electric market
4 prices and natural gas prices for fuel costs, liquidity in the wholesale market (fewer
5 counterparties and tighter credit restrictions), recoverability of natural gas and power costs,
6 streamflow and weather conditions, changes in legislative and governmental regulations,
7 relicensing hydro projects, rising construction and raw material costs and access to capital
8 markets at a reasonable cost.
9 Higher capital expenditures for environmental compliance, new generation and
10 transmission and distribution facilities are also impacting the utility sector. The significant need
11 for capital expenditures causes increased competition for financial capital. Regulation
12 supporting the full and timely recovery of prudently incurred costs is critical to the utility sector,
13 including Avista.
14 **Q. What credit rating does Avista Utilities believe is appropriate?**
15 A. Avista Utilities should operate at a level that will support a strong investment
16 grade credit rating, meaning a "BBB+" or an "A-," using S&P's rating scale. In fact, S&P stated
17 in its November 2007 U.S. Utilities and Power Commentary that "About 68% of the companies
18 in the industry carry a 'BBB' category rating (BBB+, BBB, and BBB-) and 24% are rated 'A-'
19 and above."[1] Ratios required to support this level of credit rating are included in Table 1 below.
20 Financially healthy utilities have lower financing costs which, in turn,

[1] Standard and Poor's, *U.S. Utilities And Power Commentary*, November 2007

1 benefits customers. In addition, financially healthy utilities are better able to invest in the needed
2 infrastructure over time to serve their customers, and to withstand the challenges and risks facing
3 the industry.

4 **Q. Why is it important to have a strong investment grade credit rating?**

5 A. A utility is a capital-intensive business and, as such, needs to have ready access to
6 capital markets under reasonable terms. Access is more difficult and more expensive for lower
7 rated companies. As new financing is required in the future to finance utility plant additions,
8 new customer additions, and debt maturities, the cost of new and replacement debt will be higher
9 for lower rated issuers.

10 The lower credit rating also requires the Company to post more collateral with
11 counterparties than would otherwise be required with a higher credit rating. This results in
12 increased costs. It also reduces financial flexibility since we must always maintain a certain
13 amount of capacity under our credit line for letters of credit.

14 **Q. What credit rating ratios are used by the rating agencies?**

15 A. S&P modified its electric and gas utility rankings in November 2007 to conform
16 to the "business risk/financial risk" matrix used by their corporate ratings group. The change by
17 S&P was designed to present their rating conclusions in a clear and standardized manner across
18 all corporate sectors.

19

20

21

1 S&P's financial ratio benchmarks used to rate companies such as Avista are set forth
2 below:

3 **Table 1**

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
December 31, 2007 Ratios:			
Avista Unadjusted	14.0	2.9	53.8
Avista Adjusted	13.3	2.8	58.7

4

5 The ratios above are utilized to determine the financial risk profile. Currently, Avista is
6 in the "Aggressive" category. The financial risk category along with the business risk profile
7 (Avista is in the Strong category) is then utilized in the matrix below to determine a company's
8 rating. S&P currently has Avista's corporate credit rating as a BBB-, as indicated in the table
9 below.

10 **Table 2**

Standard & Poor's Business Risk / Financial Risk Matrix

	Financial Risk Profile				
Business 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-

11

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

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

2 A. The first ratio, "Funds from operations/total debt (%)", calculates the amount of
3 cash from operations as a percent of total debt. The ratio indicates the company's ability to fund
4 debt obligations. The second ratio, "Funds from operations/interest coverage (x)", calculates the
5 amount of cash from operations that is available to cover interest requirements. This ratio
6 indicates how well a company's earnings can cover interest payments on its debt. The third ratio,
7 "Total debt/total capital (%)", is the amount of debt in our total capital structure. The ratio is an
8 indication of the extent to which the company is using debt to finance its operations. S&P looks
9 at many other financial ratios; however, these are the three most important ratios they use when
10 analyzing our financial profile.

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

13 A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet
14 commitments (for example, the accounts receivable program, purchased power agreements and
15 the unfunded status of pension and other post-retirement benefits) that negatively impact the
16 ratios. S&P has historically made adjustments to Avista's debt totaling approximately $226
17 million related to the accounts receivable program, purchased power and post-retirement
18 benefits. The adjusted financial ratios for Avista are included in Table 1 above.

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

20 A. Avista's cash flow ratios lag primarily because of high cost debt that is
21 outstanding. The cash flow ratios should improve as the 2008 debt maturities are refinanced.
22 S&P and Moody's took this into account when they upgraded Avista in December 2007 and

1 February 2008. Progress in increasing the cash flow ratios has been slower than anticipated due
2 to below normal stream flows affecting hydro generation, higher thermal fuel costs than the
3 amount included in rates and resulting inability to eliminate electric deferral balances, and higher
4 capital expenditures that require cash up front before we can recover the costs from customers.
5 Each has an impact on the Company by reducing the amount of available cash flow from
6 operations, requiring external financing and ultimately resulting in higher debt and lower cash
7 flow ratios. In fact, S&P stated the following in a January 2008 research report on Pacific
8 Northwest Hydrology:

9 We find that Avista and Idaho Power, which are comparably sized companies,
10 face the most substantial risk (related to hydro power) despite their PCAs and cost
11 update mechanisms.[2]
12
13 Additionally, S&P stated the following in its February 2008 research update of Avista
14 Corporation:

15 The Company's financial performance will continue to be significantly affected by
16 hydro conditions and gas prices. And the Company's key utility risk going
17 forward is its exposure to high-cost replacement power, particularly in low water
18 years.[3]
19
20 In order to improve the cash flow ratios, Avista must reduce its total debt balances and
21 increase its available funds from operations. Although the Company has continued to work
22 towards paying down its total debt, the negative impacts to cash flow caused by below-normal
23 hydroelectric generation and volatility of wholesale electric market prices and natural gas prices

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

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

1 in recent years, has adversely affected Avista's progress in improving the cash flow ratios.
2 Although we have reduced our Washington electric and natural gas deferral balances, the
3 balances remain at $56.9 million at December 31, 2007. The deferral balances are also an area
4 that continues to concern the rating agencies.

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

7 A. Yes, they also look at a number of qualitative factors. The rating agencies
8 evaluate the company's resource picture, the competitive environment in which we operate, the
9 regulatory environment including the timely recovery and certainty of recovery of costs, quality
10 of management and financial policy. Therefore, while the ratios are utilized in their quantitative
11 evaluation of a company, they are not the only factors that are taken into account.

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

14 A. The regulatory environment in which a company operates is a major qualitative
15 factor in determining a company's creditworthiness. Moody's stated the following regarding
16 Avista's regulatory environment in a December 2007 credit ratings report:

17 Moody's is assuming that the company's regulators in its Washington, Idaho, and
18 Oregon jurisdictions will continue to support timely and adequate recovery of, and
19 return on, the capital investments through decisions in future general rate cases
20 that we expect will be filed on a regular basis. In our overall assessment of
21 regulatory risk, the degree of support from the WUTC is more heavily weighted
22 than the degree of support from the other jurisdictions since Washington is the
23 company's largest jurisdiction, by far.[4]
24

[4] Moody's Investor Service, *Moody's Upgrades Avista Corp* (December 20, 2007)

1 Additionally, in a January 2008 article published by S&P entitled "Top Ten US Electric
2 Utility Credit Issues for 2008 and Beyond", S&P stated that "Recovering in a timely manner
3 federally and/or state mandated compliance costs is paramount to preserving credit quality for
4 regulated electric utilities."[5]

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

11

12 **IV. CASH FLOW**

13 **Q. What are the Company's sources of funding capital requirements?**

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

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

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

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

1 The amount of capital expenditures planned for 2008-2009 is approximately $390
2 million. For 2008 alone, these costs equate to a total of $190 million. Total net rate base at
3 December 31, 2007 was $1.7 billion for the total Company; therefore, these planned capital
4 additions represent substantial new investments. A few of the major capital expenditure items on
5 a system basis for 2008 include $46 million for electric transmission and distribution upgrades,
6 $43 million for electric and natural gas customer growth, $21 million for natural gas system
7 upgrades, $9 million for environmental (associated with the Spokane River relicensing and the
8 2001 Clark Fork River license implementation issues), $26 million for generation upgrades, and
9 $15 million for Jackson Prairie capacity and deliverability expansions.

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

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

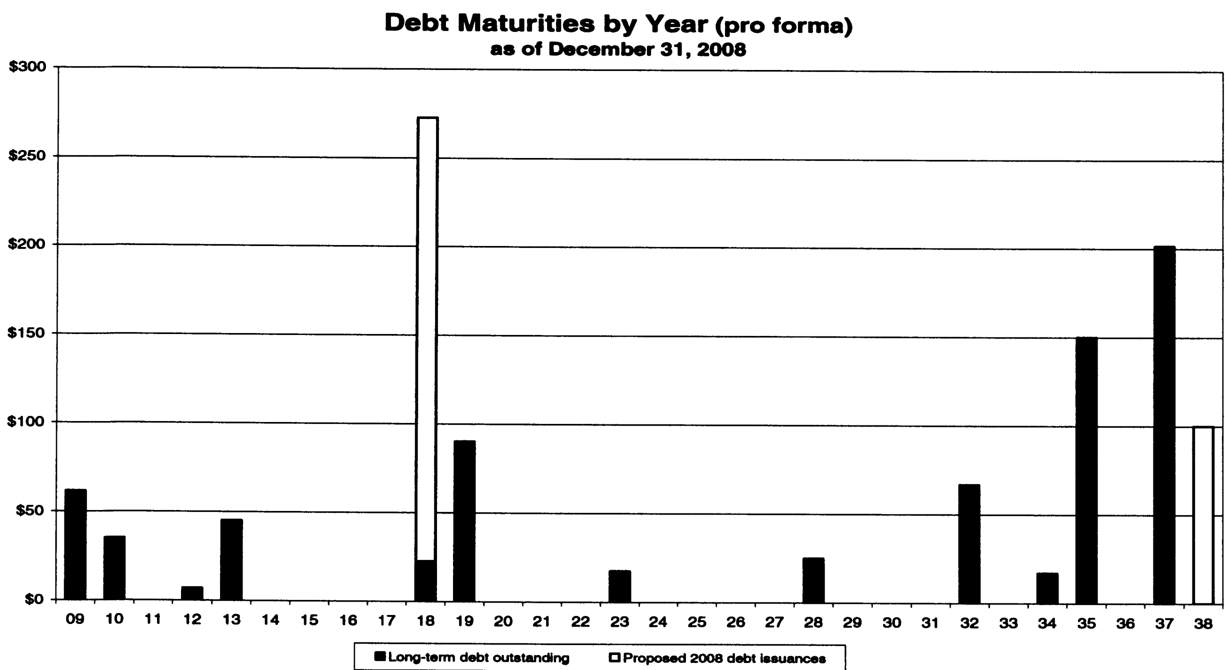
15 Major capital expenditures are a normal part of utility operations. Customers are added to
16 the service area, roads are relocated and require existing facilities to be moved, and facilities
17 continue to wear out and need replacement. These and other requirements create the need for
18 significant capital expenditures each year. We are seeing significant increases in the costs of
19 materials, including the cost of steel, cement, asphalt, and transformers. Access to capital at
20 reasonable rates is dependent upon the Company maintaining a strong capital structure, sufficient
21 interest coverage, and investment grade credit ratings.

22

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

2 A. The Company plans to issue up to $350 million of secured, fixed rate bonds
3 during 2008. The proceeds from the issuance of the securities will be utilized to fund debt
4 maturities and repay funds borrowed under our credit facility. The Company has $318 million of
5 debt maturing in 2008 and capital expenditures of approximately $190 million during 2008. The
6 proposed 2008 issuance of debt securities has been reflected in the chart below.

7



8 In addition to the $318 million of debt maturities in 2008, we have $83.7 million of
9 Pollution Control Bonds ($66.7 million with a maturity date of October 2032 and $17.0 million
10 with a maturity date of March 2034) that are subject to remarketing on December 30, 2008.
11 These bonds are puttable at the option of the security holders on December 30, 2008. If the
12 bonds cannot be remarketed on that date, we will be required to purchase the outstanding bonds.

1 In addition, we have $25 million of Medium-Term Notes with a maturity date of June 2028 that
2 are puttable at the option of the security holders in June 2008.

3 **Q. The debt maturities graph above reflects a proposed 2008 debt issuance of**
4 **$250 million maturing in 2018. Why is the Company proposing such a large maturity in**
5 **one year?**

6 A. Avista has had discussions with various investment bankers regarding our
7 proposed 2008 debt issuances. The investment bankers have indicated that investors are
8 charging a premium for debt issuance transactions that are not "index eligible", due to volatilities
9 that have occurred in the market over the past year. A debt issuance must be at least $250
10 million in order to be index eligible. The investment bankers have indicated that the premium
11 could range from 10 – 15 bps, which is $250,000 to $375,000 annually. Due to the significance
12 of the premium, Avista believes it would be beneficial to customers to issue debt that is index
13 eligible. Additionally, based upon the projected growth of Avista, the maturity will be much
14 smaller by the time the debt issuance is required to be refinanced, on a relative basis. Avista will
15 continue to monitor the capital markets and balance the impact of debt issuances on the maturity
16 graph and the cost of debt as well as the impact to customers and rates.

17 **Q. Has the Company taken any steps to address the uncertainty related to**
18 **interest rate exposure for the significant debt maturities it faces in 2008?**

19 A. Yes, it has. As a result of the historically low interest rate environment that
20 existed in 2004, the Company entered into two forward-starting interest rate swaps totaling $125
21 million or almost 46% of the June 1, 2008 debt maturity. The swaps have contract terms of ten
22 years beginning in 2008. These agreements secured a fixed rate for a significant portion of the

1 total future interest rate. These agreements only lock in a portion of Avista's credit spread. The
2 swaps will be cash settled on the same day we issue new debt securities to fund the June 1, 2008
3 maturity.

4 **Q. What other financing activities did the Company complete in 2004 through**
5 **2007 that will lower its interest costs?**

6 A. The Company completed the following financing activities from 2004 through
7 2007 that lowered interest costs:

8 **Table 3**

Description of Securities Issued	Amount (in millions)	Rate	Life
Trust Preferred Stock:			
April 2004	$60	6.50%	5
First Mortgage Bonds:			
November 2004	$90	5.45%	15
November 2005	$150	6.25%	30
December 2006	$150	5.70%	30.5

9

10 The financing activity described in the Table above has had a direct impact on the
11 Company's debt costs. Cost of total debt has decreased from 8.44% at December 31, 2003 to
12 7.88% at December 31, 2007. The cost of debt should decrease significantly once the 2008 debt
13 maturities are refinanced, as evidenced by the pro forma cost of debt of 6.38% as of December
14 31, 2008 reflected in this filing.

15 **Q. What is the status of the Company's line of credit secured by first mortgage**
16 **bonds and its accounts receivable program?**

17 A. The Company has a $320 million line of credit that expires in April 2011. The
18 Company has the option of increasing the line by $100 million (up to $420 million) at any time

1 during the term of the agreement, subject to additional fees and obtaining bank commitments.
2 The agreement includes the option to release the first mortgage bond security when the Company
3 has an investment grade credit rating. Additionally, the Company has an $85 million accounts
4 receivable funding program that expires in March 2008. The Company does not anticipate
5 having any difficulties renewing the facility. This demonstrates increased confidence by our
6 banks in Avista's financial condition.

7 The facilities have been sized to allow the Company to fund at least one year of capital
8 expenditures, plus required working capital and counterparty collateral requirements to assure
9 flexibility given both the volatile financial markets and volatile energy commodity prices.

10 Many purchases of natural gas, or contracts for pipeline capacity to provide natural gas
11 transportation, require collateral, and/or prepayments, based upon the Company's credit rating.
12 Upgrades to Avista's credit ratings during 2007 and 2008 have reduced the amount of collateral
13 required to be posted with counterparties. If Avista is upgraded above its current credit ratings,
14 the collateral requirements are expected to decrease, resulting in reduced borrowing costs. The
15 line of credit and accounts receivable program are our primary sources of immediate cash for
16 borrowing to meet these needs and for supporting the use of letters of credit. A line of credit is
17 required to manage daily cash flow since the timing of cash receipts versus cash disbursements is
18 never totally balanced.

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

21 A. Avista will continue to monitor the common equity ratio of its capital structure.
22 We will continuously assess the need to issue additional common equity based upon our overall

1 capital structure. Avista entered into a sales agency agreement in December 2006 to issue up to
2 two million shares of our common stock from time to time. During the second half of 2008, we
3 are planning to issue common stock under this sales agency agreement in order to maintain our
4 equity ratio at an appropriate level. It is important to the rating agencies who rate the Company's
5 securities, and hence an important component of the Company's cost of doing business, for
6 Avista to maintain a balanced debt/equity ratio in order to minimize the risk of default on
7 required debt interest payments. Avista is committed to maintaining an appropriate level of
8 equity to support a strong credit rating.

9 **Q. What is the status of the Company's progress in meeting the prior**
10 **commitment to increase the equity layer at the Utility?**

11 A. The utility equity component was 45.4% as of December 31, 2007, an increase of
12 7.3% from the year-end 2006 ratio of 38.1%. Avista Utilities is meeting the minimum utility
13 equity ratios that were agreed to with the WUTC (i.e. of 35% by the end of 2007 and 38% by the
14 end of 2008). Avista expects to remain at or above the current equity level, and thus will
15 continue to meet the required equity ratios, assuming normal weather and water conditions.

16 The more flexibility the Company has by maintaining access to both the debt and equity
17 markets, the stronger our financial condition will become. The ability to earn our allowed return
18 on equity would continue to build the equity ratio, and improve the Company's financial
19 condition. It is also important to have a higher common equity ratio in the event adverse
20 conditions occur.

21

22

1 **Q. What are Avista's plans regarding preferred equity and other financing**
2 **structures (for example hybrid instruments)?**
3 A. Avista does not have any preferred equity or other financing structures
4 outstanding at December 31, 2007. Currently, Avista does not plan to issue preferred equity or
5 other financing structures. Avista will continue to evaluate the appropriateness of preferred
6 equity and other financing structures within its overall capital structure.
7
8 **V. CAPITAL STRUCTURE**
9 **Q. Please explain the capital structure proposed by Avista in this case.**
10 A. Avista's current capital structure consists of a blend of short-term debt, long-term
11 debt and common equity necessary to support the assets and operating capital of the Company.
12 The proportionate shares of Avista Corp.'s actual capital structure on December 31, 2007, are
13 shown on page 2 of Exhibit No. __(MKM-2). A pro forma capital structure is also shown on
14 page 2 in the Exhibit, which reflects expected changes for the period ending December 31, 2008.
15 Supporting workpapers provide additional details related to these adjustments on pages 3 through
16 5.
17 The rate of return to be applied to rate base in this proceeding is equal to the weighted
18 average cost of capital, taking into account the pro forma adjusting items. As shown on page 2
19 of Exhibit No. __(MKM-2), Avista Utilities is proposing an overall rate of return of 8.43%.
20
21
22

1 **VI. COST OF DEBT**

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

3 A. Cost of debt in the Company's proposed capital structure includes short-term and
4 long-term debt. As shown on page 2 of Exhibit No. ___(MKM-2), the actual weighted average
5 cost of total debt outstanding on December 31, 2007 was 7.88%. The size and mix of debt
6 changes over time based upon the actual financing completed. We have made certain pro forma
7 adjustments to update the debt cost through December 31, 2008 to 6.38%. Pro forma
8 adjustments to long-term debt reflect expected maturities of outstanding debt and the issuance of
9 new debt to fund those maturities. The pro forma weighted cost of total debt was reduced from
10 4.21% to 3.43%.

11 The level of short-term debt is based on the monthly average projected balance
12 outstanding during 2008. The cost of short-term debt is based on our costs of borrowing under
13 our corporate credit facility along with a forward curve of short-term LIBOR rates for 2008. This
14 estimated forward curve is based on information accessed through Thomson One market
15 information.

16

17 **VII. COST OF COMMON EQUITY**

18 **Q. What rate of return on common equity is the company proposing in this**
19 **proceeding?**

20 A. The company is proposing a 10.8% return on common equity (ROE), which is
21 within the lower end of Dr. Avera's recommended range of required return on equity. Dr. Avera

1 testifies to analyses related to the cost of common equity with an ROE range of 10.7% to 12.2%.

2 In his testimony Dr. Avera states that:

3 Considering investors' expectations for capital markets and the need to
4 support financial integrity and fund crucial capital investment even
5 under adverse circumstances, I concluded that Avista's requested ROE
6 of 10.8% percent is reasonable. (P. 5, L. 6-9)
7

8 **Q. Dr. Avera suggests an ROE range of 10.7% to 12.2%. Why is Avista**

9 **requesting an ROE on the lower end of the range?**

10 A. As I have testified, Avista has made solid progress towards improving its financial

11 health. If Avista can earn a 10.8% ROE in 2009, I believe the financial condition would continue

12 to improve and would further strengthen the credit ratings ratios.

13 Furthermore, as the Company has worked toward improving its financial condition over

14 the last several years, it has done so with the customer in mind. Avista is attempting to balance

15 the ability to continue to improve our financial health and access capital markets with the impacts

16 that increased retail rates have on its customers. In this case, although we believe an ROE

17 greater than 10.8% is supported and is warranted, we also believe the 10.8% provides a

18 reasonable balance of the competing objectives.

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1 **Q. Please summarize the proposed capital structure and the cost components for**
2 **debt and common equity.**
3 A. As also shown on page 2 of Exhibit No. ___(MKM-2), the following table shows
4 the capital structure and cost components proposed by the Company.
5 **Table 4**

PRO FORMA

Cost of Capital as of December 31, 2008	Amount	Percent of Total Capital	Cost	Component
Total Debt	$1,149,158,000	53.70%	6.38%	3.43%
Common Equity	990,683,000	46.30%	**10.80%**	5.00%
TOTAL	$2,139,841,000	100.00%		**8.43%**

6
7 **Q. Does that conclude your pre-filed direct testimony?**
8 A. Yes.