Exhibit No. ____ (MTT-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-10________

DOCKET NO. UG-10________

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 degree with majors in Accounting and Business
9 Administration from Saint Ambrose College in Davenport, Iowa, and became a Certified Public
10 Accountant in 1987. I have extensive experience in finance, risk management, accounting and
11 administration 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.

1 The proposed rate of return is derived from Avista's total cost of debt including long-term and
2 short-term debt, and common equity, weighted in proportion to the proposed capital structure.
3 I will address the proposed capital structure, as well as the proposed cost of total debt and
4 equity in this filing. Dr. Avera, on behalf of the Company, will provide additional testimony
5 related to the appropriate return on equity for Avista, based on the specific circumstances of the
6 Company, together with the current state of the financial markets.
7 In brief, I will provide information that shows:

8-17
- Avista's plans call for significant capital expenditure requirements for the utility over the next two years to assure reliability in serving our customers and meeting customer growth. Capital expenditures of approximately $420 million[1] are planned for 2010-2011 for customer growth, investment in generation upgrades, transmission and distribution facilities for the electric utility business as well as necessary maintenance and replacements of our natural gas utility systems. Capital expenditures of approximately $1.2 billion are planned for the five year period ending December 31, 2014. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms.

18
19-28
- Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB- and Baa3 from Moody's Investors Service (Moody's). Avista must operate at a level that will support a strong investment grade corporate credit rating, meaning "BBB" or "BBB+", in order to access capital markets at reasonable rates, which will decrease long-term borrowing costs to customers. Avista has been placed on "positive" outlook by both S&P and Moody's, which may result in an upgrade as early as August 2010. A supportive regulatory environment will be taken into consideration by the rating agencies when reviewing Avista for a possible upgrade. Maintaining solid credit metrics and credit ratings will also help support a stock price necessary to issue equity to fund capital requirements.

29

[1] This does not include investment in "Smart Grid" projects. Avista was awarded matching grants from the U.S. Department of Energy for two "Smart Grid" projects. One project will upgrade portions of the utility's electric distribution system to smart grid standards in Spokane, Washington, and the other project is a demonstration project in Pullman, Washington that involves automation of many parts of the electric distribution system using advanced metering, enhanced utility communication and other elements of smart grid technologies.

1 • The Company has proposed an overall rate of return of 8.33%, including a
2 48.39% equity ratio and a 10.9% return on equity. Our cost of debt is 5.93%. We
3 believe the 8.33% provides a reasonable balance of the competing objectives of
4 continuing to improve our financial health, and the impacts that increased rates
5 have on our customers.
6
7 The Company's initiatives to carefully manage its operating costs and capital
8 expenditures are an important part of improving performance, but are not sufficient without
9 revenues from the general rate request for our electric and natural gas businesses in these cases.
10 Certainty of cash flows from operations can only be achieved with the support of regulators in
11 allowing the timely recovery of costs and the ability to earn a fair return on investment.

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

13 A. Yes. I am sponsoring Exhibit No.___(MTT-2) pages 1 through 5, which were
14 prepared under my direction. Avista's credit ratings by S&P and Moody's as summarized on
15 page 1, and Avista's actual capital structure at December 31, 2009 and pro forma capital
16 structure at December 31, 2010 are included on page 2, with supporting information on pages 3
17 through 5 of the exhibit.

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

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20	I.	Introduction	1
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25	VI.	Cost of Debt	27
26	VII.	Cost of Common Equity	28

27

1 **II. FINANCIAL OVERVIEW**

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

3 A. The Company has made solid progress in improving its financial health in recent
4 years, as demonstrated by improved financial ratios. Avista has reduced investments in
5 unregulated subsidiaries and redeployed the majority of the proceeds from the sales of the
6 unregulated subsidiaries to the Utility. The Company has been able to improve and balance its
7 debt and equity ratios by paying down debt, issuing additional common stock, and through
8 additional retained earnings. Although we have made progress in improving the Company's
9 financial condition, we are still not as strong as we need to be.

10 Avista's goal is to operate at a level that will support a strong corporate credit rating of
11 BBB / BBB+, and move away from the bottom notch of the investment grade rating scale.
12 Operating at a higher rating will help reduce long-term costs to customers. It will also reduce
13 collateral requirements and allow us to maintain access to more counterparties for acquisition of
14 natural gas and electricity. We expect that a continued focus on the regulated utility,
15 conservative financing strategies (including the issuance of common equity) and a supportive
16 regulatory environment will contribute to an overall improved financial situation, that will allow
17 us to move up from the current BBB- rating.

18 Avista was placed on "positive" outlook by both S&P and Moody's in August 2009,
19 which indicates that continued financial improvement and prudent financial management could
20 lead to an upgrade. This may not be achieved, however, if there are significant drought
21 conditions or negative impacts to the company's hydro generating facilities, if the Company does
22 not obtain adequate and timely support for recovery of costs from state regulators, if there are

1 significant changes in wholesale energy prices, or if the company's financial metrics otherwise
2 deteriorate.

3 **Q. What additional steps is the Company taking to improve its financial health?**

4 A. We are working to assure we have adequate funds for operations, capital
5 expenditures and debt maturities. We are maintaining a $320 million line of credit and a $75
6 million line of credit, which will both expire in April 2011, as well as an Accounts Receivable
7 Sales program. We plan to obtain a portion of our capital requirements through equity issuance.
8 We also maintain an ongoing dialogue with the rating agencies regarding the measures taken by
9 the Company to improve our credit rating.

10 We have reduced our overall cost of debt from approximately 6.5% in 2008 to 5.6% at
11 December 31, 2009, primarily by issuing $250 million of secured debt at a coupon of 5.125%.

12 We are operating the business efficiently to keep costs as low as practicable for our
13 customers, while at the same time ensuring that our energy service is reliable, and customers are
14 satisfied. An efficient, well-run business is not only important to our customers, but also to
15 investors. Additionally, the Company is working through regulatory processes to recover our
16 costs in a timely manner so that earned returns are closer to those allowed by regulators in each
17 of the states we serve. This is one of the key determinants from the rating agencies' standpoint
18 when they are reviewing our overall credit ratings.

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

21 A. It is absolutely essential. Avista has two primary sources of external capital –
22 debt and equity investors. Avista currently has approximately $2.4 billion of debt and equity in

1 place to serve its customers. Approximately half of that investment is funded by debt holders,
2 and half is funded by equity investors. There tends to be a lot of emphasis on maintaining credit
3 metrics and credit ratings that will provide access to debt capital under reasonable terms,
4 however, access to equity capital is equally important. In fact, equity investors also focus on
5 cash flows, capital structure and liquidity, as do debt investors.

6 Additional equity capital generally comes in two forms – retained earnings and new
7 equity issuances. Retained earnings represent the annual earnings (return on equity) of the
8 Company that is not paid out to investors in dividends. The retained earnings are reinvested by
9 the Company in utility plant, and other capital requirements, to serve customers, which avoids
10 the need to issue new debt. Occasionally it is necessary to issue new common stock to maintain
11 a balanced debt and equity capital structure, which allows Avista access to both debt and equity
12 markets under reasonable terms, on a sustainable basis. Because of the large capital requirements
13 at Avista, it is imperative that Avista have ready-access to both the debt and equity markets at
14 reasonable costs.

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

16 A. Yes. Our ability to attract new capital, especially equity capital, under reasonable
17 terms is dependent on our ability to offer a risk/reward opportunity that is better than the equity
18 investors' other alternatives. We are competing with not only other utilities, but businesses in
19 other sectors of the economy. Demand for the stock supports the stock price, which provides the
20 opportunity to issue additional stock under reasonable terms to fund capital investment
21 requirements.

1 To the extent that the equity investor holds a diversified portfolio of companies that
2 includes utilities and other energy companies, we would be competing with those companies to
3 attract those equity dollars.
4 In the debt markets, utilities are the third largest issuers, right behind governments and
5 financial services. Therefore, it is a very competitive market and the Company must be able to
6 attract debt investors as well as equity investors.
7 **Q. What is Avista doing to attract equity investment?**
8 A. Avista is carrying a capital structure that provides the opportunity to have
9 financial metrics that offer a risk/reward proposition that is competitive and/or attractive for
10 equity holders.
11 We have increased our dividend for common shareholders, and have publicly stated that
12 we intend to work toward a dividend payout ratio that is comparable to other utilities in the
13 industry. This is an essential element in providing a competitive risk/reward opportunity for
14 equity investors.
15 We are operating the business efficiently to keep costs as low as practicable for our
16 customers, while at the same time ensuring that our energy service is reliable, and customers are
17 satisfied.
18 We are employing tracking mechanisms such as the Energy Recovery Mechanism (ERM)
19 and Purchased Gas Adjustment (PGA), approved by the regulatory commissions, to balance the
20 risk of owning and operating the business in a manner that places us in a position to offer a
21 risk/reward opportunity that is competitive with not only other utilities, but with businesses in
22 other sectors of the economy.

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

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

Q. Has regulatory lag reduced the actual return earned by the Company?

A. Yes. Although we have received additional rate increases within the last year in all three states where we do business, we are continuing to experience increases in costs, and increased capital investment requirements. As an example, our most recent rate case in Washington included recovery of a portion of the new capital investment in 2009, but none for 2010 (except for the Noxon facility upgrade). What that means is, we are not recovering the costs associated with the new capital investment we have already made in 2009 and 2010, and will continue to make, until the conclusion of this rate case later this year.

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

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

1 **III. CREDIT RATINGS**

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

3 A. Utilities need ready access to capital markets in all types of economic
4 environments. The nature of our business with long-term capital projects, our obligation to
5 serve, and the potential for high volatility in fuel and purchased power markets, necessitates the
6 ability to go to the financial markets under reasonable terms on a regular basis.

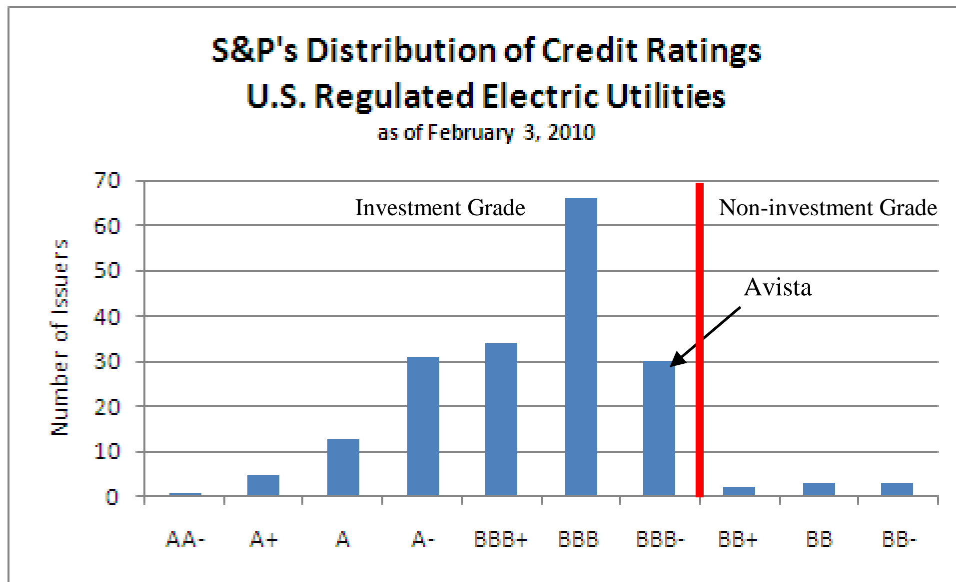
7 **Q. Please explain the credit ratings for Avista's debt securities.**

8 A. Rating agencies are independent agencies that assess risks for investors. Two of
9 the most widely recognized rating agencies are S&P and Moody's. These rating agencies assign
10 a credit rating to companies and their securities so investors can more easily understand the risks
11 associated with investing in their debt and preferred stock. Avista's credit ratings are
12 summarized on page 1 of Exhibit No.___(MTT-2).

13 As shown in Illustration No. 1 below, Avista is on the lowest rung of the investment
14 grade credit rating scale. As I noted earlier, I believe it is important that we move up the scale to
15 at least a BBB or BBB+, so that we are not on the edge of the investment grade cliff.

16

1 **Illustration No. 1:**



2

3 Additionally, as shown in Illustration No. 2 below, Avista has the lowest corporate credit

4 rating among its Northwest peers.

5 **Illustration No. 2:**

Avista Corporation Peer Comparison - S&P Corporate Issuer Rating

	Avista	IDACORP	Portland General Electric	Northwestern	Puget Sound Energy
Corporate Issuer Rating	BBB-	BBB	BBB	BBB	BBB

6

7 **Q. Please explain the implications of the credit ratings in terms of the**

8 **Company's ability to access financial markets.**

9 A. Credit ratings impact investor demand and expected return. More specifically,

10 when the company issues debt, the credit rating helps determine the interest rate at which the

1 debt will be issued. The credit rating also determines the type of investor who will be interested
2 in purchasing the debt. For each type of investment a potential investor could make, the investor
3 looks at the quality of that investment in terms of the risk they are taking and the priority they
4 would have in the event that the organization experiences severe financial stress. Investment
5 risks include the likelihood that a company will not meet all of its debt obligations in terms of
6 timeliness and amounts owed for principal and interest. Secured debt receives the highest ratings
7 and priority for repayment and, hence, has the lowest relative risk. In challenging credit markets,
8 where investors are less likely to buy corporate bonds (as opposed to U.S. Government bonds), a
9 higher credit rating will attract more investors, and a lower credit rating could reduce or eliminate
10 the number of potential investors. Thus, lower credit ratings may result in a company having
11 more difficulty accessing financial markets and/or incur significantly higher financing costs.

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

13 A. The move to investment grade for Avista Corp was a significant step in improving
14 the Company's ability to access capital at a reasonable cost. However, a credit rating at the
15 bottom of investment grade is not appropriate for Avista. In adverse conditions – whether
16 unique to Avista or by all market participants – a downgrade from BBB- (investment grade) to
17 BB+ (non-investment grade) is significantly harder to overcome than a downgrade from BBB to
18 BBB-. As Avista experienced, it took approximately six years for the Company to regain its
19 investment grade rating from S&P after it was downgraded during the energy crisis. The
20 difference between investment grade and non-investment grade is not only a matter of debt
21 pricing, it can be a matter of not having the ability to access markets. To avoid adverse
22 circumstances, Avista Utilities should operate at a level that will support a strong corporate

1 investment grade credit rating, meaning a "BBB" or "BBB+," using S&P's rating scale. As
2 shown in illustration 1 above, BBB+/BBB is the average rating of U.S. regulated electric utilities.
3 The Company's goal is to have a credit rating of at least average (our current credit rating is
4 below average).

5 As noted in Dr. Avera's testimony, the Chairman of the New York State Public Service
6 Commission noted in his role as spokesman for the National Association of Regulatory Utility
7 Commissioners the following:

> 8 While there is a large difference between A and BBB, there is an even
> 9 brighter line between Investment Grade (BBB-/Baa3 bond ratings by
> 10 S&P/Moody's, and higher) and non-Investment Grade (Junk) (BB+/Ba1
> 11 and lower). The cost of issuing non-investment grade debt, assuming
> 12 the market is receptive to it, has in some cases been hundreds of basis
> 13 points over the yield on investment grade securities. To me this suggests
> 14 that you do not want to be rated at the lower end of the BBB range
> 15 because an unexpected shock could move you outside the investment
> 16 grade range. ((Exhibit No.___(WEA-1T) P. 27, L. 17 to P. 28, L. 6).

17

18 A solid investment grade credit rating would also allow the Company to post less
19 collateral with counterparties than would otherwise be required with a lower credit rating. This
20 results in lower costs. It also increases financial flexibility since the credit line capacity would
21 not be reduced for outstanding letters of credit.

22 Financially healthy utilities have lower financing costs which, in turn, benefit customers.
23 In addition, financially healthy utilities are better able to invest in the needed infrastructure over
24 time to serve their customers, and to withstand the challenges and risks facing the industry.

25 **Q. What financial metrics are used by the rating agencies to establish credit**
26 **ratings?**

1 A. S&P's financial ratio benchmarks used to rate companies such as Avista are set
2 forth in Illustration No. 3 below.

3 **Illustration No. 3:**
4

Standard & Poor's Financial Risk Indicative Ratios

	FFO/Debt (%)	FFO/Interest (x)	Debt/Capital (%)
Minimal	Greater than 60	(a)	Less than 25
Modest	45 - 60	(a)	25 - 35
Intermediate	30 - 45	(a)	35 - 45
Significant	20 - 30	(a)	45 - 60
Aggressive	12 - 20	(a)	50 - 60
Highly leveraged	Less than 12	(a)	Greater than 60
12 Months Ended 12/31/09 Ratios:			
Avista Adjusted [b]	13.9%	3.71x	57.5%

[a] Not available, however, S&P has indicated that it is a benchmark ratio used for the Utility industry.
[b] Calculated as of 12/31/09 based on last known S&P methodology

5
6 The ratios above are utilized to determine the financial risk profile. Currently, Avista is
7 in the "Aggressive" category. The financial risk category along with the business risk profile
8 (Avista is in the Excellent category) is then utilized in Illustration No. 4 below to determine a
9 company's rating. S&P currently has Avista's corporate credit rating as a BBB-. Based upon an
10 aggressive financial risk profile and excellent business risk profile, Avista should have a
11 corporate credit rating of BBB (as indicated in the following table). S&P has placed Avista on
12 "positive" outlook, which indicates that continued financial improvement and prudent financial
13 management could lead to an upgrade. This may not be achieved, however, if the Company does

1 not obtain adequate and timely support for recovery of costs from state regulators, there are
2 significant drought conditions or negative impacts to the Company's hydro generating facilities,
3 there are significant changes in wholesale energy prices, or the Company's financial metrics
4 otherwise deteriorate.

5 **Illustration No. 4:**
6

Standard & Poor's Business and Financial Risk Profile Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA	AA	A	A-	BBB	-
Strong	AAA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	-	BBB-	BB+	BB	BB-	B
Weak	-	-	BB	BB-	B+	B-
Vulnerable	-	-	-	B+	B	CCC+

7
8 Moody's uses a similar methodology to analyze and determine utility credit ratings and
9 has also placed Avista Corporation on "positive" outlook.

10 **Q. If Avista is not upgraded at its next review by the credit rating agencies, how**
11 **long may it take for Avista to be upgraded?**

12 A. S&P and Moody's are both scheduled to review Avista's credit ratings in August
13 2010. If Avista is not upgraded at that time, Avista could be placed on an outlook of "stable". If
14 Avista is placed on a stable outlook, it may take an additional 3 years before Avista is upgraded
15 one notch.

1 **Q. Please describe how S&P's Financial Risk ratios are calculated and what**
2 **they mean?**
3 A. The first ratio, "Funds from operations/total debt (%)", calculates the amount of
4 cash flow from operations as a percent of total debt. The ratio indicates the company's ability to
5 fund debt obligations. The second ratio, "Funds from operations/interest coverage (x)",
6 calculates the amount of cash from operations that is available to cover interest requirements.
7 This ratio indicates how well a company's earnings can cover interest payments on its debt. The
8 third ratio, "Total debt/total capital (%)", is the amount of debt in our total capital structure. The
9 ratio is an indication of the extent to which the company is using debt to finance its operations.
10 S&P looks at many other financial ratios; however, these are the three most important ratios they
11 use when analyzing our financial profile.
12 **Q. Do rating agencies make adjustments to the financial ratios that are**
13 **calculated directly from the financial statements of the Company?**
14 A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet
15 commitments (for example, the accounts receivable program, purchased power agreements and
16 the unfunded status of pension and other post-retirement benefits) that negatively impact the
17 ratios. In 2008, S&P made adjustments to Avista's debt totaling approximately $247 million
18 related to the accounts receivable program, purchased power and post-retirement benefits. The
19 adjusted financial ratios for Avista are included in Illustration No. 3 above.
20 **Q. Where does Avista fall within those coverage ratios?**
21 A. Progress in increasing the cash flow ratios in recent years has been slower than
22 anticipated due to higher capital expenditures that require cash up front before we can recover the

1 costs from customers and below normal stream flows affecting hydro generation. Each has an
2 impact on the Company by reducing the amount of available cash flow from operations, requiring
3 external financing and ultimately resulting in higher debt and lower cash flow ratios. In fact,
4 S&P stated the following in an August 2009 credit review of Avista Corporation:

5 Progress could be derailed by a worsening recessionary environment, very adverse
6 hydro conditions that lead to large deferral balances, or rate case activity that does
7 not yield timely and sufficient regulatory relief in Idaho and Washington.[2]
8
9 Additionally, Moody's stated the following in its August 2009 credit review of Avista
10 Corporation:

11 What could change the rating down: Failure to obtain adequate and timely support
12 for recovery of costs from any of the commissions having jurisdiction in Avista's
13 operating territories could pressure ratings. Significant drought conditions or
14 negative impacts of any kind to the company's hydro generating facilities would
15 be a significant credit negative.[3]
16
17 In order to improve the cash flow ratios, Avista must reduce its debt to total capitalization
18 ratio and increase its available cash funds from operations.

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

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

24 ▪ Regulation
25 ▪ Markets

[2] Standard and Poor's, *Global Credit Portal Avista Corporation, August 2009*
[3] Moody's Investor Services, *Credit Opinion: Avista Corp. Global Credit Research, August 2009*

1 ▪ Operations

2 ▪ Competitiveness, and

3 ▪ Management

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

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

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

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

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

1 for financial capital at a time when the average utility credit rating is just above investment grade
2 (i.e. BBB / BBB+) and Avista is lower at BBB-.

3 Given the downturn in the economy and the tightened credit markets, the rating agencies
4 are keeping closer tabs on all companies in order to make sure there is sufficient liquidity in case
5 the credit markets are inaccessible. Not having sufficient sources of cash for potential cash
6 requirements could prompt a credit rating downgrade. The rating agencies are concerned about
7 the significant amount of bank credit facilities that will need to be refinanced or addressed in
8 2010 through 2012. They expect that over $110 billion of bank credit facilities will need to be
9 refinanced during this time. This is expected to create significant competition for bank credit and
10 will result in increased fees as well as a reduction in the size of facilities.

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

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

15 A. The regulatory environment in which a company operates is a major qualitative
16 factor in determining a company's creditworthiness. Moody's stated the following regarding
17 Avista's regulatory environment in an August 2009 credit ratings report:

18 Given the highly regulated nature of Avista's operations, the Company's primary
19 credit ratings driver is the degree of supportiveness that the Company receives
20 from its various regulatory authorities.[4]
21
22 S&P stated the following:

[4] Moody's Investor Service, *Credit Opinion: Avista Corp. Global Credit Research,* August 2009

> Regulation is the most critical aspect that underlies regulated integrated utilities' creditworthiness. Regulatory decisions can profoundly affect financial performance. Our assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory process to be considered supportive of credit quality, it must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag, especially when a utility engages in a sizable capital expenditure program.[5]

S&P also stated the following regarding Avista:

> The company's chief risk is the electric utility's exposure to replacement power costs, particularly in low water years, which its fuel and purchased-power mechanisms in Idaho and Washington partially mitigate. How the company manages its regulatory relationships in its three jurisdictions is an important component of credit quality and stability.[6]

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

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[5] Standard and Poors, Key Credit Factors: Business and Financial Risks in the Investor-owned Utilities Industry, March 2010.
[6] Standard and Poors, *Global Credit Portal Avista Corporation,* August 2009

1 **IV. CASH FLOW**

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

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

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

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

12 The amount of capital expenditures planned for 2010-2011 is approximately $420 million
13 and approximately $1.2 billion for the five year period ending December 31, 2014. For 2010
14 alone, these costs equate to a total of approximately $210 million. Total company ratebase at
15 December 31, 2009 was $2.1 billion; therefore, these planned capital additions represent
16 substantial new investments given the relative size of the Company.

17 A few of the major capital expenditure items on a system basis for 2010 include $57
18 million for electric transmission and distribution upgrades, $16 million for natural gas system
19 upgrades, $9 million for environmental (associated with the Spokane River relicensing and the
20 2001 Clark Fork River license implementation issues), $35 million for generation upgrades and
21 $29 million for customer connects.

1 Major capital expenditures are a normal part of utility operations. Customers are added to
2 the service area, roads are relocated and require existing facilities to be moved, and facilities
3 continue to wear out and need replacement. These and other requirements create the need for
4 significant capital expenditures each year. Access to capital at reasonable rates is dependent
5 upon the Company maintaining a strong capital structure, sufficient interest coverage, and
6 investment grade credit ratings.

7 **Q. What are the Company's long-term capital requirements related to new**
8 **energy resources?**

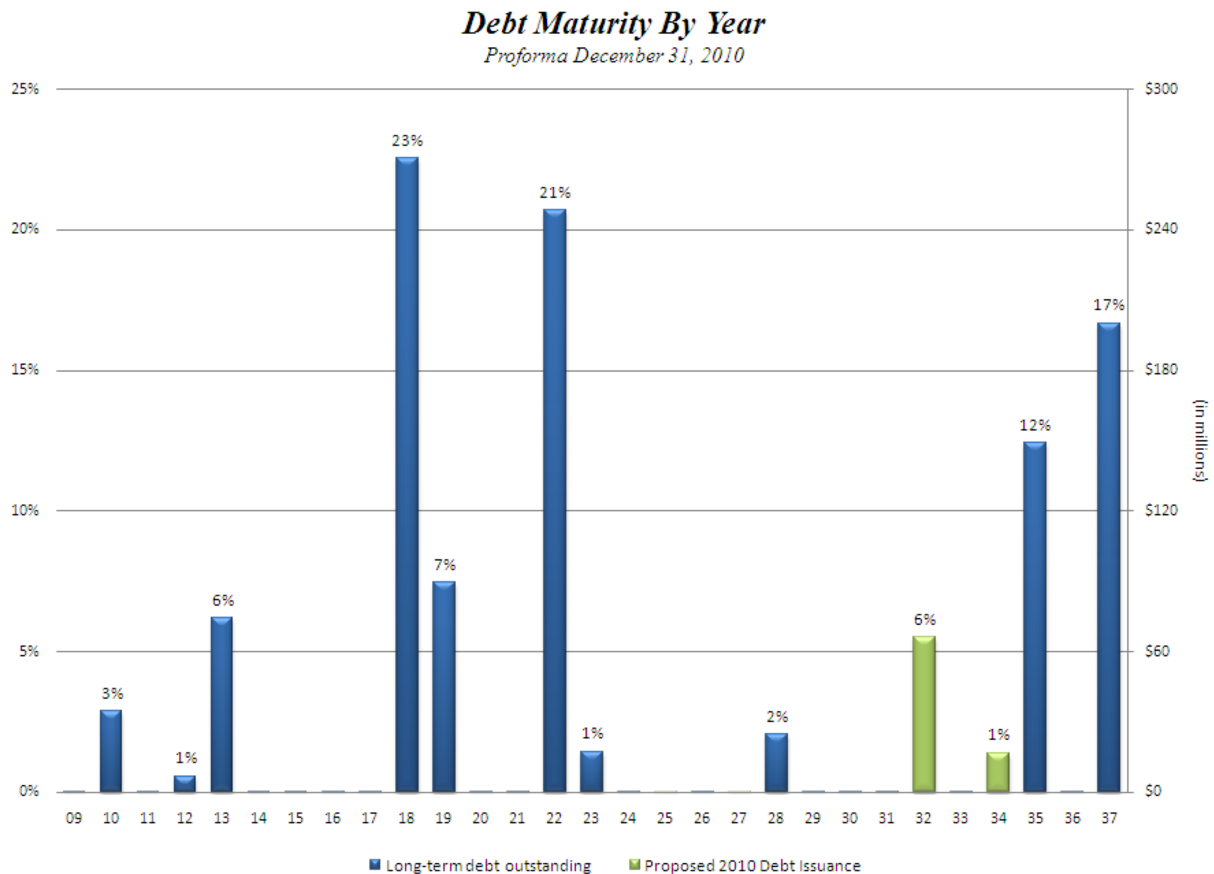
9 A. Avista's Integrated Resource Plan has identified the potential need for the
10 Company to finance significant expenditures for electric facilities. The preferred strategy
11 outlined in our 2009 Integrated Resource Plan included total expenditures of $1.25 billion by
12 2020, including investment in wind resources and combined-cycle combustion turbines (to meet
13 customer load) as well as upgrades at hydroelectric stations.

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

15 A. The Company issued $280 million of secured debt in 2008, and $250 million of
16 secured debt in 2009. The $250 million secured debt was issued at a coupon of 5.125% in
17 September 2009. The Company's original plan was to issue long-term secured debt in
18 September 2008. Due to the disruption in the financial markets, the Company elected to defer
19 the issuance until September 2009. The Company instead sought out and was able to establish a
20 second bank line of credit to ensure continued adequate liquidity. The Company was able to
21 reduce interest costs by approximately $80 million over a ten year period (approximately $8
22 million annually) by deferring the issuance of long-term debt from 2008 to 2009.

1 The Company currently plans to issue up to $83.7 million of secured debt in 2010. The
2 proceeds from the issuance of the securities will be utilized to fund capital expenditures, repay
3 maturing long-term debt and repay funds borrowed under our credit facilities. The Company has
4 $35 million long-term debt scheduled to mature in 2010. Illustration No. 5 below shows the
5 amount of debt maturities for Avista each year:

6 **Illustration No. 5:**



7

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

1 A. The Company has a $320 million line of credit, and a $75 million line of credit
2 that both expire in April 2011. Additionally, the Company has a $50 million accounts receivable
3 funding program that expires in March 2011. This agreement has historically been renewed on a
4 year-to-year basis.
5 The costs related to our $320 million line are expected to increase (when it is refinanced)
6 due to the tightened credit markets and competition for bank credit. The increased costs are
7 evident in our $75 million credit agreement that was completed in November 2009.
8 The facilities have been sized to allow the Company to maintain adequate liquidity to
9 cover working capital requirements, manage counterparty collateral requirements, and avoid
10 issuing securities in unfavorable markets. We believe our current agreements provide us
11 adequate liquidity and flexibility to face volatile financial markets and volatile energy commodity
12 prices.
13 Many purchases of natural gas, or contracts for pipeline capacity to provide natural gas
14 transportation, require collateral, and/or prepayments, based upon the Company's credit rating.
15 Upgrades to Avista's credit ratings during 2007 and 2008 have reduced the amount of collateral
16 required to be posted with counterparties. If Avista is upgraded above its current credit ratings,
17 the Company should see an increase in the number of counterparties willing to do business with
18 us and the collateral requirements are expected to decrease even further, resulting in reduced
19 costs.
20 The lines of credit and accounts receivable program are our primary sources of immediate
21 cash for borrowing to meet these needs and the lines of credit support the issuance of letters of

credit. These credit facilities are required to manage daily cash flow since the timing of cash receipts versus cash disbursements is never totally balanced.

Q. Is there pending legislation that may impact the Company's collateral requirements?

A. Yes. In December 2009 the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the House Bill) which would establish regulatory jurisdiction by the Commodity Futures Trading Commission (CFTC) for certain swaps (which includes a variety of derivative instruments) and the users of such swaps. Under the House Bill, "major swap participants" would be required to register with the CFTC and, among other things, maintain minimum capital and margin requirements. "Major swap participants" would include entities with large swap positions, excluding swaps held primarily for hedging commercial risk. Since we use derivative instruments primarily for hedging commercial risks, it is unlikely that we would be subject to the proposed CFTC regulation.

The House Bill would also require a broad category of swaps to be cleared and traded on registered exchanges or special derivatives exchanges. Such clearing requirements could impose a significant change from our current practices of bilateral transactions and negotiated credit terms. Clearing requirements could involve greater liquidity as collateral. However, there would be an exemption, available on an individual basis, for an end user that is not a major swap participant, and we believe we would qualify for such an exemption.

Although the House Bill may not have a material direct adverse effect on us, concern remains that our counterparties who are not exempt would pass along increased costs and margin requirements through higher prices and reductions in unsecured credit limits. In addition, there

1 can be no assurance that any final legislation affecting derivatives, if enacted, would retain the
2 exemptions contained in the House Bill.

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

5 A. Avista will continue to monitor the common equity ratio of its capital structure,
6 and assess the need to issue additional common equity. Avista entered into an amended and
7 restated sales agency agreement in December 2009 to issue up to 1.25 million shares of our
8 common stock from time to time. Avista originally entered into a sales agency agreement to
9 issue up to 2 million shares of its common stock in December 2006. In 2008, we issued 750,000
10 shares of common stock under this sales agency agreement. We are planning to issue up to $45
11 million of common stock in 2010 in order to finance a portion of our capital expenditures and
12 maturing long-term debt and to support our common equity ratio. To the extent that we are not
13 able to access the equity market, there will be increased pressure on our lines of credit, and an
14 increased need to issue long term debt, which is likely to unfavorably impact our cost of debt and
15 debt-to-equity ratio. It is important to the rating agencies for Avista to maintain a balanced
16 debt/equity ratio in order to minimize the risk of default on required debt interest payments.

17 As Dr. Avera explains in his testimony, the 48.39 percent common equity ratio requested
18 by Avista in this case is consistent with the range of equity ratios maintained by the firms in the
19 Utility Proxy Group.

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

1 common equity ratio, is consistent with increasing uncertainties and the need to maintain the
2 continuous access to capital that is required to fund operations and necessary system investment.
3 In his testimony Dr. Avera states that:

4 My conclusion is reinforced by the investment community's focus on the
5 need for a greater layer to accommodate higher operating risks and the
6 pressures of funding significant capital investments. This is reinforced
7 by the need to consider the impact of uncertain capital market
8 conditions, as well as off-balance sheet commitments such as purchased
9 power agreements, which carry with them some level of imputed debt
10 ((Exhibit No. ___(WEA-1T), P. 6, L. 26 to P. 7, L. 2).
11

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

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

18 A. Avista does not have any preferred equity or other financing structures
19 outstanding at December 31, 2009. Currently, Avista does not plan to issue preferred equity or
20 other financing structures, but will continue to evaluate the appropriateness of these financing
21 vehicles.
22

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 December 31, 2009, 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 5.

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 2
12 of Exhibit No.___(MTT-2), Avista Utilities is proposing an overall rate of return of 8.33%.

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, 2009
18 through December 31, 2010). As shown on page 2 of Exhibit No.___(MTT-2), the actual
19 weighted average cost of total debt outstanding on December 31, 2009 was 5.60%. The size and
20 mix of debt changes over time based upon the actual financing completed. We have made
21 certain pro forma adjustments to update the debt cost through December 31, 2010 to 5.93%,
22 which is a reduction from the 6.57% currently allowed in rates. Pro forma adjustments to total

1 debt reflect expected maturities of outstanding long-term debt, issuance of new debt to fund
2 those maturities and the expected monthly average of short-term debt for the pro forma period.
3

4 **VII. COST OF COMMON EQUITY**

5 **Q. What rate of return on common equity is the Company proposing in this**
6 **proceeding?**

7 A. The Company is proposing a 10.9% return on common equity (ROE), which falls
8 at the lower end of Dr. Avera's recommended range of required return on equity. Dr. Avera
9 testifies to analyses related to the cost of common equity with an ROE range of 10.9% to 12.5%
10 and 11.1% to 12.7% (after accounting for the impact of common equity flotation costs). In his
11 testimony Dr. Avera states that:

12 Because Avista's requested ROE of 10.9 percent falls at the very bottom
13 of my "bare bones" cost of equity range, it represents a conservative
14 estimate of investors' required rate of return. ((Exhibit No. ___(WEA-
15 1T), P. 4, L's 25-27)
16

17 **Q. Dr. Avera suggests an ROE range of 10.9% to 12.5%. Why is Avista**
18 **requesting an ROE at the lower end of the range?**

19 A. As I have testified, Avista has made solid progress towards improving its financial
20 health. If Avista can earn a 10.9% ROE, I believe our financial condition would continue to
21 improve and would further strengthen the credit ratings ratios.

22 Furthermore, as the Company has worked toward improving its financial condition over
23 the last several years, it has done so with the customer in mind. Avista is attempting to balance
24 the ability to continue to improve our financial health and access capital markets under

1 reasonable terms with the impacts that increased retail rates have on its customers. In this case,
2 although we believe an ROE greater than 10.9% is supported and is warranted, we also believe
3 the 10.9% provides a reasonable balance of the competing objectives.

4 **Q. Please summarize the proposed capital structure and the cost components for**
5 **debt and common equity.**

6 A. As also shown on page 2 of Exhibit No.___(MTT-2), the following illustration
7 shows the capital structure and cost components proposed by the Company.

8 **Illustration No. 6:**

AVISTA CORPORATION
Cost of Capital
December 31, 2010

	Amount	Percent of Total Capital	Cost	Component
Total Debt	$1,228,462,129	51.61%	5.93%	3.06%
Common Equity	1,151,660,792	48.39%	10.90%	5.27%
Total	$2,380,122,921	100.00%		**8.33%**

9

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

11 A. Yes.