BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-12\_\_\_\_\_\_\_\_

DOCKET NO. UG-12\_\_\_\_\_\_\_\_

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

# I. INTRODUCTION

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

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

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

A. I received a Bachelor of Arts degree in 1986, with majors in Accounting and Business Administration from Saint Ambrose College in Davenport, Iowa, and became a Certified Public Accountant in 1987. I have extensive experience in finance, risk management, accounting and administration within the utility sector.

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

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

A. I will provide a financial overview of the Company and will explain the overall rate of return proposed by the Company in this filing for its electric and natural gas operations. The proposed rate of return is derived from Avista’s total cost of debt including long-term and short-term debt, and common equity, weighted in proportion to the proposed capital structure.

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

In brief, I will provide information that shows:

* 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 $500 million are planned for 2012-2013 for customer growth, investment in generation upgrades, transmission and distribution facilities, and information technology systems 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, 2016. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms.
* Avista’s corporate credit rating from Standard & Poor’s (S&P) is currently BBB and Baa2 from Moody’s Investors Service (Moody’s). Avista must operate at a level that will support a solid investment grade corporate credit rating in order to access capital markets at reasonable rates, that will positively affect long-term costs to customers. A supportive regulatory environment is an important consideration by the rating agencies when reviewing Avista. Maintaining solid credit metrics and credit ratings will also help support a stock price necessary to issue equity under reasonable terms to fund capital requirements.
* The Company is proposing an overall rate of return of 8.25%, including a 48.4% equity ratio and a 10.90% return on equity. Our pro forma cost of debt is 5.76%.

The Company’s initiatives to carefully manage its operating costs and capital expenditures are an important part of our performance, but are not sufficient without revenues from the general rate request for our electric and natural gas businesses in these cases. Sufficient cash flows from operations can only be achieved with the support of regulators in allowing the timely recovery of costs and the ability to earn a reasonable return on our rate base assets.

A table of contents for my testimony is as follows:

Description Page

I. Introduction 1

II. Financial Overview 3

III. Credit Ratings 9

IV. Cash Flow 16

V. Capital Structure 22

VI. Cost of Debt 23

VII. Cost of Common Equity 23

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

A. Yes. I am sponsoring Exhibit No.\_\_\_ (MTT-2) pages 1 through 6, which were prepared under my direction. Avista’s credit ratings by S&P and Moody’s are summarized on page 1, and Avista’s actual capital structure at December 31, 2011 and pro forma capital structure at December 31, 2012 are included on page 2, with supporting information on pages 3 through 6 of the Exhibit.

**II. FINANCIAL OVERVIEW**

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

A. The Company continues to make solid progress in improving its financial health in recent years, as demonstrated by improved financial ratios and recent credit rating upgrades. The Company has been able to improve and balance its debt and equity ratios through issuances of debt and common stock, and through additional retained earnings.

Avista’s goal is to operate at a level that will support a solid corporate credit rating of at least BBB with a long-term goal of operating at a corporate credit rating of BBB+. Operating at these rating levels will positively affect long-term costs to customers. We expect that a continued focus on the regulated utility, conservative financing strategies (including the issuance of common stock) and a supportive regulatory environment will contribute to operating at this rating level.

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

**Q. What additional steps has the Company taken to improve its financial health?**

A. We are working to assure there are adequate funds for operations, capital expenditures and debt maturities. We have extended the average weighted maturity of long-term debt and the overall cost of debt was 5.72% as of December 31, 2011.

During 2010 and 2011, the Company issued long-term debt at historically low rates that included two thirty year bond issuances, a ten year bond issuance, and a three year bond issuance. Cumulatively, these issuances extended the weighted average maturity of outstanding debt. The following are details of these issuances:

December 2011:

* $85.0 million of secured debt at a coupon of 4.45 percent due in 2041.

December 2010:

* $52 million of secured debt at a coupon of 3.89% due in 2020,
* $35 million of secured debt at a coupon of 5.55% due in 2040, and
* $50 million of secured debt at a coupon of 1.68% due in 2013.

In February 2011, Avista entered into a new committed line of credit in the amount of $400 million with an expiration date of February 2015 to replace two committed lines of credit that were expiring.

The Company continued to monitor this market and in December 2011, amended the $400 million committed line of credit. This executed amendment extended the expiration date to February 10, 2017 from February 11, 2015 and improved the pricing terms as shown in the following illustration.

**Illustration No. 1:**



The Company has entered into forward starting interest rate swap agreements (with cumulative notional amounts of $75 million for 2012 and $85 million for 2013) as a hedge on a portion of the interest payments on the long-term debt we are planning to issue in 2012 and 2013. The Company has entered into forward starting interest rate swaps to reduce its interest rate risk associated with forecasted issuances of long-term debt. The Company is continuing to analyze the possibility of entering into additional transactions in order to hedge the interest rate risk on future long-term debt issuances.

We obtain a portion of our capital requirements through issuing common equity. In 2011, we issued $26.5 million, and in 2010, we issued $46.2 million of common stock. We are planning to issue up to $45 million of common stock in 2012 in order to maintain our capital structure at an appropriate level for our business.

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

A. It is absolutely essential. Avista has two primary sources of external capital – debt and equity investors. As of December 31, 2011, Avista had approximately $2.6 billion of debt and equity. Approximately half of that investment is funded by debt holders, and the other half is funded by equity investors and retained earnings. There tends to be a lot of emphasis on maintaining credit metrics and credit ratings that will provide access to debt capital under reasonable terms, however, access to equity capital is equally important. In fact, equity investors also focus on cash flows, capital structure and liquidity, as do debt investors. In fact, the level of common equity in the Company’s capital structure can have a direct impact on its’ credit rating.

Additional equity capital generally comes in two forms: retained earnings and new equity issuances. Retained earnings represent the annual earnings of the Company that is not paid out to investors in dividends. The retained earnings are reinvested by the Company in utility plant, and other capital requirements, to serve customers, which avoids the need to issue new debt or new equity. Occasionally, it’s necessary to issue common equity in order to maintain a balanced debt and equity capital structure, which allows Avista access to both debt and equity markets under reasonable terms, on a sustainable basis. Because of the large capital requirements at Avista, it is imperative that Avista have ready-access to both the debt and equity markets at reasonable costs. As previously noted, our capital requirements for the next five years are sizable at approximately $1.2 billion, as compared to our current rate base of $2.2 billion.

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

A. Yes. Our ability to attract new capital, especially equity capital, under reasonable terms is dependent on our ability to offer a risk/reward opportunity that is at least commensurate with equity investors’ other alternatives. We are competing with not only all other investor owned public utilities, but businesses in other sectors of the economy. Demand for the stock supports the stock price, which provides the opportunity to issue additional stock under reasonable terms to fund capital investment requirements.

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

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

We have steadily increased our dividend for common shareholders over the past several years, to work toward a dividend payout ratio that is comparable to other utilities in the industry. This is an essential element in providing a competitive risk/reward opportunity for equity investors.

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

Certain equity investors look for investments that provide a competitive dividend payout and the opportunity for appreciation in stock price through earnings growth. If we are not able to achieve a reasonable actual earned return on our equity investment, our earnings growth will be limited. This limitation could affect the appreciation in our stock price. If appreciation is not realized it would reduce the overall total return to investors. A reduction in total return would make it difficult to attract, under reasonable terms, 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 rate increases in recent years, we are continuing to experience increases in costs, and increased capital investment requirements that are not reflected in retail rates. What that means is we are not recovering the costs associated with significant new capital investment that is already in place providing service to customers.

It is important that we work toward 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.

The retail rates authorized by the Commission at the conclusion of this proceeding should provide a reasonable opportunity for Avista to actually earn a return on equity more closely in line with that authorized by the Commission. Company witness Norwood addresses this issue in greater detail. (See Exhibit No. \_\_\_ KON-1T)

### III. CREDIT RATINGS

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

A. Avista needs ready access to capital markets in all types of economic environments. The nature of our business with long-term capital projects, our obligation to serve, and the potential for high volatility in fuel and purchased power markets, necessitates the need to have the ability to go to the financial markets under reasonable terms on a regular basis. In order to have this ability, investors need to understand the risks related to any of their investments. In order to help investors assess the creditworthiness of Avista, Nationally Recognized Statistical Rating Organizations (rating agencies) developed their own standardized ratings scale, otherwise known as credit ratings. These credit ratings indicate the financial strength of a company. These rating agencies assign ratings to most of our bond issues to assist investors in determining the credit risk of debt issuers.

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

A. Two of the most widely recognized rating agencies are S&P and Moody’s. These rating agencies assign a credit rating to companies and their securities so investors can more easily understand the risks associated with investing in their debt and preferred stock[[1]](#footnote-1). Credit ratings have a direct impact on the cost of debt to customers to finance utility infrastructure, and have a direct correlation with the interest rate the Company must pay in order to attract investors. Avista’s credit ratings are summarized on page 1 of Exhibit No.\_\_\_ (MTT-2).

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

A. Credit ratings can impact investor demand and expected return. More specifically, when the Company issues debt, the credit rating is one factor that helps determine the interest rate at which the debt will be issued. The credit rating also can determine the type of investor who will be interested in purchasing the debt. For each type of investment a potential investor could make, the investor looks at the quality of that investment in terms of the risk they are taking and the priority they would have in the event that the organization experiences severe financial stress. Investment risks include the likelihood that a company will not meet all of its debt obligations in terms of timeliness and amounts owed for principal and interest. Secured debt can receive a higher rating because of its priority for repayment and, hence, has the lowest relative risk. In challenging credit markets, where investors are less likely to buy corporate bonds (as opposed to U.S. Government bonds), a higher credit rating could attract more investors, and a lower credit rating could reduce the number of potential investors. Thus, lower credit ratings may result in the Company having more difficulty accessing financial markets and/or incur significantly higher financing costs.

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

A. The move to investment grade for Avista Corp was a significant step in improving the Company’s ability to access capital at a reasonable cost. As Avista experienced, it took approximately six years for the Company to regain its investment grade rating from S&P and Moody’s after it was downgraded during the energy crisis. The difference between investment grade and non-investment grade is not only a matter of debt pricing, but also the ability to access markets. To avoid adverse circumstances, Avista should operate at a level that will support our current corporate investment grade credit rating, while having a long-term goal of operating at a “BBB+” corporate credit rating using S&P’s rating scale.

As shown in Illustration No. 2, below Avista’s current S&P corporate credit rating of BBB is below the average credit rating for U.S. Regulated Combined Gas and Electric Utilities. The Company’s long-term goal is to operate at a credit rating of at least the utility average (BBB+). Operating at a BBB+ could lower the Company’s debt pricing and attract additional investors. To achieve this goal, regulatory support is necessary in order to reduce the lag the Company is currently experiencing related to the timely recovery of costs, which should improve the Company’s cash flow metrics, along with the opportunity to earn a reasonable return.

**Illustration No. 2:**



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

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

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

**Illustration No. 3:**

|  |  |  |  |
| --- | --- | --- | --- |
| **Standard & Poor's Financial Risk Indicative Ratios** | | | |
| **(Corporate)** | | | |
|  | | |  |
|  | **FFO/Debt (%)** | **Debt/Capital (%)** |  |
| **Minimal** | Greater than 60 | Less than 25 |  |
| **Modest** | 45 - 60 | 25 - 35 |  |
| **Intermediate** | 30 - 45 | 35 - 45 |  |
| **Significant** | 20 - 30 | 45 - 50 |  |
| **Aggressive** | 12 - 20 | 50 - 60 |  |
| **Highly leveraged** | Less than 12 | Greater than 60 |  |
|  |  |  |  |
| **12 Months Ended 12/31/11 Ratios:** | |  |  |
|  |  |  |  |
| **Avista Adjusted (a)** | **18.50%** | **54.90%** |  |
| **(a) Calculated as of 12/31/11 based on last known S&P methodology** | | |  |

The ratios above are utilized to determine the financial risk profile. Currently, Avista is in the “Aggressive” category. The financial risk category along with the business risk profile (Avista is in the Excellent category) is then utilized in Illustration No. 4 below to determine a company’s rating. S&P currently has Avista’s corporate credit rating as a BBB, based upon an “Aggressive” financial risk profile and “Excellent” business risk profile.

**Illustration No. 4:**



The Company’s aggressive financial risk profile reflects higher leverage than that of other corporate industrial issuers and cash flow coverage in the high teens[[2]](#footnote-2).

Moody’s uses a similar methodology to analyze and determine utility credit ratings.

**Q. Please describe how S&P’s Financial Risk ratios are calculated and what they mean?**

A. The first ratio, “Funds from operations/total debt (%)”, calculates the amount of cash flow from operations as a percent of total debt. The ratio indicates the company’s ability to fund debt obligations. The second ratio, “Total debt/total capital (%)”, is the amount of debt in our total capital structure. The ratio is an indication of the extent to which the company is using debt to finance its operations. S&P looks at many other financial ratios; however, these are two important ratios they use when analyzing our financial profile.

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

A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet commitments (e.g., purchased power agreements and the unfunded status of pension and other post-retirement benefits) that negatively impact the ratios. For example, in 2011 S&P made adjustments to Avista’s debt totaling approximately $148 million primarily related to purchased power, post-retirement benefits, and non-recourse debt. The adjusted financial ratios for Avista are included in Illustration No. 3 above.

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

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

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

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

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

A. The regulatory environment in which a company operates is a major qualitative factor in determining a company’s creditworthiness.

S&P stated the following:

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.[[3]](#footnote-3)

Due to the major capital expenditures planned by Avista, a supportive regulatory environment will be essential in minimizing or eliminating the regulatory lag we are currently experiencing. Our financial health is a major factor in maintaining our current rating and equally important in achieving our long-term goal of BBB+, which is the average rating for U.S. Regulated Combined Gas and Electric Utilities.

### IV. CASH FLOW

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

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

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

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

We have been making significant capital investments in generation, transmission and distribution systems to preserve and enhance service reliability for our customers and replace aging infrastructure. Utility capital expenditures were $247.0 million for 2011.

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 $257 million are planned for 2012 for customer growth, investment in generation upgrades, transmission and distribution facilities, and information technology systems as well as necessary maintenance and replacements of our natural gas utility systems.

The capital budget for 2012 includes the following (dollars in millions):

**Illustration No. 5:**



Capital expenditures of approximately $1.2 billion are planned for the five-year period ending December 31, 2016. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms.

Total Company rate base as of December 31, 2011, was $2.2 billion; therefore, these planned capital additions represent substantial new investments given the relative size of the Company. Failure to timely recover these costs will create regulatory lag for the Company’s investors, and weaken the Company’s credit metrics with rating agencies.

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

A. The Company finances its rate base assets with long term debt and equity. As such, from time to time, we need to access long-term capital markets in order to finance these long-term assets as well as fund maturing debt.

In 2012, the Company plans on issuing $75 million of First Mortgage Bonds with a tenure of 30 years. Illustration No. 6 below shows the amount of debt maturities for Avista each year including the maturity date of forecasted long-term debt issuances:

**Illustration No. 6:**



**Q. What is the status of the Company’s committed line of credit agreement secured by first mortgage bonds?**

A. In February 2011, Avista entered into a four-year committed line of credit in the amount of $400 million with an expiration date of February 2015. This committed line of credit replaced the $320 million and $75 million committed line of credit agreements that had an expiration date of April 2011. The new committed line of credit is secured by $400 million of non-transferable First Mortgage Bonds of the Company. As noted above, in December 2011, the Company amended the $400 million committed line of credit to extend the expiration date to February 10, 2017 from February 11, 2015 and improved the pricing terms.

The facility has been sized to allow the Company to maintain adequate liquidity to cover daily cash needs, manage counterparty collateral requirements, and avoid issuing securities in unfavorable markets. We believe our current agreement provides us adequate liquidity to manage our daily cash flow needs and provides the Company flexibility to face volatile financial markets and volatile energy commodity prices.

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

A. Yes. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted into law in July 2010. The Dodd-Frank Act establishes regulatory jurisdiction by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) for certain swaps (which include a variety of derivative instruments) and the users of such swaps that previously had been largely exempted from regulation.

A variety of rules must be adopted by federal agencies (including the CFTC, SEC and the FERC) to implement the Dodd-Frank Act. These rules being developed and implemented will clarify the impact of the Dodd-Frank Act on Avista Corp., which may be significant.

Under the Dodd-Frank Act, “Swap Dealers” and “Major Swap Participants” generally will be required to collect minimum initial and variation margin from their counterparties for non-cleared swaps. However the requirement varies with the type of counterparty and the regulator of the “Major Swap Participant” or “Swap Dealer.” Avista Corp. should be categorized as a counterparty that is a non-financial end user for the purposes of Dodd-Frank, i.e., as a non-financial entity that engages in derivatives to hedge commercial risk. Under a proposed rule issued by the CFTC, swap dealers and major swap participants subject to regulation by the CFTC would not be required to collect initial or variation margin from counterparties that are non-financial end users. The SEC has not yet issued a proposed rule with respect to security-based swap dealers or security based major swap participants. However, notwithstanding levels of margin required by regulation (or the lack thereof), concern remains that swap dealer and major swap participant counterparties will pass along their increased capital and interdealer margin costs through higher prices and reductions in thresholds for posting.

The Dodd-Frank Act also requires swaps to be cleared and traded on exchanges or swap execution facilities. Such clearing requirements would result in a significant change from our current practice of bilaterally negotiated credit terms. An exemption to mandatory clearing is available under Dodd-Frank for counterparties that are non-financial end users; however, the cost of entering into a non-cleared swap that is available as a cleared swap may be greater.

We will continue to monitor developments including certain proposals to delay various implementation steps defined in the Act. We cannot predict the impact the Dodd-Frank Act may ultimately have on our operations.

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

A. Avista continuously monitors the common equity ratio of its capital structure, and assesses the need to issue additional common equity. In 2011, we issued $26.5 million, and in 2010, we issued $46.2 million of common stock. In 2012, in order to maintain our capital structure at an appropriate level for our business, we plan on issuing approximately $45 million of common stock. It is important to the rating agencies and investors for Avista to maintain a balanced debt/equity ratio in order to minimize the risk of default on required debt interest payments. Dr. Avera notes that:

Utilities are facing energy market volatility, rising cost structures, the need to finance significant capital investment plans, uncertainties over accommodating economic and financial market uncertainties, and ongoing regulatory risks. Coupled with the potential for turmoil in capital markets, these considerations warrant a stronger balance sheet to deal with an increasingly uncertain environment. A more conservative financial profile, in the form of a higher common equity ratio, is consistent with increasing uncertainties and the need to maintain the continuous access to capital under reasonable terms that is required to fund operations and necessary system investment, including times of adverse capital market conditions. (Exhibit No. \_\_\_ (WEA-1T), P. 31, ll. 10-19).

Additionally, Dr. Avera concludes that the 48.4 percent common equity ratio is reasonable based on the following:

• Avista’s requested capitalization is consistent with the Company’s need to maintain its credit standing and financial flexibility as it seeks to raise additional capital to fund significant system investments and meet the requirements of its service territory;

• Avista’s proposed common equity ratio is entirely consistent with the 49.5 percent and 50.3 percent average common equity ratios for the proxy utilities, based on year-end 2011 data and near-term expectations, respectively; and,

• The requested capitalization reflects the importance of an adequate equity layer to accommodate Avista’s operating risks and the pressures of funding significant capital investments. This is reinforced by the need to consider the impact of uncertain capital markets conditions, as well as off-balance sheet commitments such as purchased power agreements, which carry with them some level of imputed debt. (Exhibit No. \_\_\_ (WEA-1T), P. 6, l. 17 – P. 7, l. 2).

### V. CAPITAL STRUCTURE

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

A. Avista’s current capital structure consists of a blend of long-term debt, and common equity necessary to support the assets and operating capital of the Company. Short-term debt is also included. Short-term debt provides liquidity to cover daily cash needs, manage counterparty collateral requirements, and avoid issuing securities in unfavorable markets. The proportionate percentages of Avista Corp.’s pro forma capital structure are 48.4% common equity, and 51.6% total debt as shown on page 2 of Exhibit No.\_\_\_ (MTT-2).

**Q. Does Avista make adjustments to debt and equity balances reported in its Form 10-K to calculate the regulatory capital structure?**

Yes. The company provides a reconciliation of these adjustments on page 6 of Exhibit No.\_\_\_ (MTT-2).

**VI. COST OF DEBT**

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

A. Cost of total debt in the Company’s proposed capital structure includes long-term debt and the forecasted monthly average of short-term debt (for the period December 31, 2011 through December 31, 2012). As shown on page 2 of Exhibit No.\_\_\_ (MTT-2), the forecasted weighted average cost of debt outstanding on December 31, 2012 is 5.76%. The size and mix of debt changes over time based upon the actual financing completed. We have made certain pro forma adjustments to update the debt cost through December 31, 2012. Pro forma adjustments to total debt reflect the issuance of new debt and the forecasted monthly average of short-term debt for the pro forma period.

### VII. COST OF COMMON EQUITY

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

A. The Company is proposing a 10.9% return on common equity (ROE), which falls essentially at the midpoint of Dr. Avera’s recommended range of required return on equity. Dr. Avera testifies to analyses related to the cost of common equity with an ROE range of 10.0 percent to 11.4 percent range, or 10.2 percent to 11.6 percent after incorporating an adjustment to account for the impact of common equity flotation costs. In his testimony Dr. Avera states that:

* + My conclusion that a 10.9 percent ROE for Avista is a reasonable estimate of investors’ required return is also reinforced by the greater uncertainties associated with Avista’s relatively small size, the economic reality that Avista’s actual returns have fallen consistently short of the allowed ROE, and the fact that current cost of capital estimates are likely to understate investors’ requirements at the time the outcome of this proceeding becomes effective and beyond. (Exhibit No.\_\_\_(WEA-1T), at P.5, ll. 25-30)

With regard to the Weighted Cost of Equity (ROE x equity layer), the following graph shows the weighted cost of equity (WCOE) authorized by state commissions for the most recent rate cases of the Utility Proxy Group in Dr. Avera’s testimony. The Illustration below shows that the majority of WCOEs are above 5.0%.

**Illustration No. 7:**



I believe this weighted cost of equity of 5.27% (10.9% ROE x 48.4% equity layer) would allow Avista to successfully compete for investors in equity markets.

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

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

**Illustration No. 8:**



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

##### A. Yes.

1. As Dr. Avera notes in his testimony, “Although the credit rating agencies are not immune to criticism, their rankings and analyses are widely cited in the investment community and referenced by investors. Investment restrictions tied to credit ratings continue to influence capital flows, and credit ratings are also frequently used as a primary risk indicator in establishing proxy groups to estimate the cost of common equity.” (Exhibit No.\_\_\_(WEA-3), at P. 6. ll. 4-9) [↑](#footnote-ref-1)
2. Standard and Poor’s, *Ratings Summary: Avista Corp., July 2011* [↑](#footnote-ref-2)
3. Standard and Poor’s, Key Credit Factors: Business and Financial Risks in the Investor-owned Utilities Industry*,* November 2008. [↑](#footnote-ref-3)