Exh. MTT-1T

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-20________

DOCKET NO. UG-20________

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

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

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 Andersen & Co. in Chicago, Illinois.

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

A. I will provide a financial overview of Avista Corporation as well as explain our credit ratings and the Company's proposed capital structure and overall rate of return in this case. Company witness Mr. McKenzie will provide additional testimony related to the appropriate return on equity for Avista, based on our specific circumstances, together with the current state of the financial markets. I will provide an overview of our capital expenditures program, and other witnesses will provide details on what capital expenditures we are making, and why they are necessary in the time frame in which they are planned.

In brief, I will provide information that shows:

1. Avista's plans call for a continuation of utility capital investments in generation, transmission, electric and natural gas distribution systems and technology to preserve and enhance service reliability for our customers, including the continued replacement of aging infrastructure. Capital expenditures of $405 million per year (system) are planned for the five-year period ending December 31, 2024. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms, on a sustainable basis.

2. We are proposing an overall rate of return of 7.43 percent, which includes a 50 percent common equity ratio, a 9.9 percent return on equity, and a cost of debt of 4.97 percent. We believe our proposed overall rate of return of 7.43 percent and the proposed capital structure provide a reasonable balance between safety and economy.

3. Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB and Baa2 from Moody's Investors Service. 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. 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.

A table of contents for my testimony is as follows:

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

A. Yes. I am sponsoring Exh. 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. Avista's proposed capital structure and cost of capital are included on page 2, with supporting information on pages 3 through 6. Confidential Exh. MTT-3C is our Interest Rate Risk Management Plan. Exh. MTT-4 is the Company's 2020 Infrastructure Investment Plan. Confidential Exh. MTT-5C shows the Company's planned capital expenditures and long-term debt issuances by year for 2021-2024.

II. FINANCIAL OVERVIEW

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

A. Avista has and will continue to operate 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 our customers are satisfied. An efficient, well-run business is not only important to our customers but also important to investors. Our capital financing plan, and our execution of that plan, provides a prudent capital structure and liquidity necessary for utility operations. We initiate regulatory processes to recover our costs in a timely manner with the goal of achieving earned returns close to those allowed by regulators in each of the states we serve. These elements – cost management, and ready access to capital and revenues that support operations – are key determinants to the rating agencies when they are reviewing our overall credit ratings.

Q. What steps is the Company taking to maintain and improve its financial health?

A. We are working to assure there are adequate funds for operations, capital expenditures and debt maturities. We obtain a portion of these funds through the issuance of long-term debt and common equity. We actively manage risks related to the issuance of long-term debt through our interest rate risk mitigation plan and we maintain a proper balance of debt and common equity through regular issuances and other transactions. We actively manage energy resource risks and other financial uncertainties inherent in supplying reliable energy services to our customers. We create financial plans and forecasts to model our income, expenses and investments, providing a basis for prudent financial planning. We seek timely recovery of our costs through general rate cases and other ratemaking mechanisms.

The Company currently has a sound financial profile and it is very important for Avista to maintain and enhance its financial position in order to access debt and equity financing under reasonable terms as Avista funds significant future capital investments and refinances maturing debt.

III. CAPITAL EXPENDITURES

Q. What is the Company's recent history related to capital investments?

A. Avista is making significant capital investments in our natural gas distribution system, electric generation, transmission and distribution facilities, and new technology to better serve the needs of our customers. These investments are focused on, among other things, the preservation and enhancement of safety, service reliability and the replacement of aging infrastructure. For the period 2015 through 2019, our capital expenditures averaged approximately $425 million per year, on a system basis (i.e., Washington, Idaho, and Oregon, electricity and natural gas). While there are variations among the functional areas targeted for investment each year, the predominant areas have included natural gas distribution plant, electric generation, transmission and distribution facilities, new customer hookups, environmental and regulatory requirements, information technology and other supporting functions, such as fleet services and facilities.

Q. Please explain how Avista identifies and prioritizes capital investments, and why the investments are made in the time frame they are completed.

A. I will summarize why Avista is making capital investments in the time frame they are being completed, and the process we use for identifying and prioritizing those investments. Company witnesses Mr. Thackston, Ms. Rosentrater, and Mr. Kensok provide details of the majority of our completed capital projects. While other specific projects, such as the Company's investments in the Western Energy Imbalance Market (EIM), Wildfire Resiliency Plan (Wildfire Plan), and Customer Facing Technology are discussed by Company witnesses Mr. Kinney, Mr. Howell and Mr. Magalsky, respectively. Those witnesses address why they need to be done in the planned time frame, and what the risks and consequences are of not completing the projects in that time frame. Company witnesses Ms. Schultz and Ms. Andrews discuss the pro forma capital adjustments and overall net rate base pro formed in this general rate case.

As discussed in greater detail in Exh. MTT-4, Avista's 2020 "Infrastructure Investment Plan", our process to identify and prioritize capital investment is designed to meet the overall need for investment, in the appropriate time frame, in a manner that best meets the future needs and expectations of our customers, in both the short-term and long-term. The Company's practice has been to constrain the level of capital investment each year, such that not all of the prioritized projects and programs[1] will be funded in a given year at the level requested. Avista believes that holding capital spending below the level requested accomplishes several important objectives, including:

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

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

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

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

Avista currently has chosen to stabilize the level of annual capital spending at what can be described as a constrained level of $405 million (system), in an effort to accomplish the objectives described above.

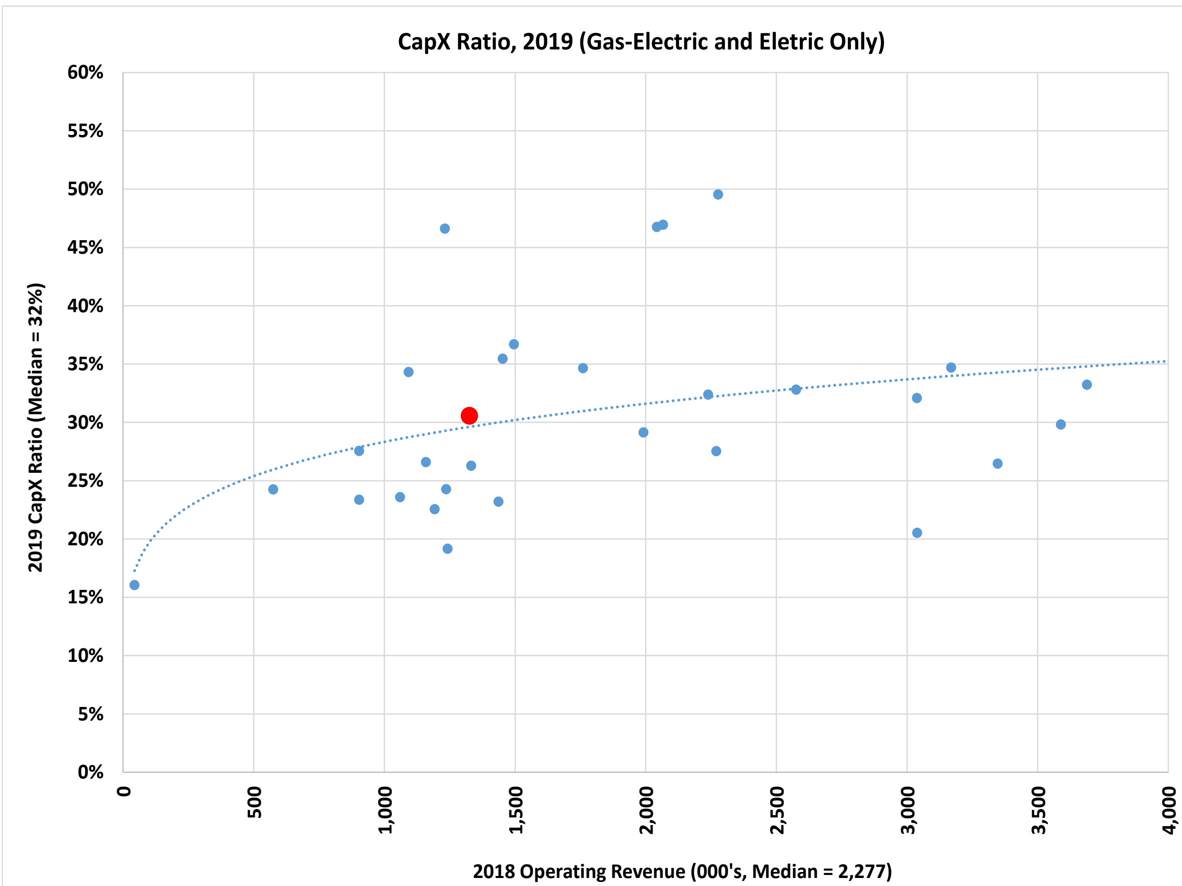
Q. How does the Company's current level of capital spend compare with other similarly sized utilities?

A. It is important to first note that the driver of capital expenditures is driven by the needs of the business so that we can continue to provide safe and reliable natural gas and electric service for our customers. With that said, the Company recently did some high-level analysis to see if our level of capital spend was in line with other similarly sized utilities. What the analysis showed was that Avista, at a system level, was pretty much right in the

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

median as compared to other similarly sized utilities. Illustration No. 1 below provides just one look – a comparison of total capital expenditures as a percentage of total operating revenue. In the end, Avista is spending approximately 32 percent of operating revenue on capital investment, which is just above the trendline for all utilities who have operating revenues below $4 billion.

<u>Illustration No. 1</u>



Q. As Avista removes old equipment and replaces it with new, does the depreciation component currently included in retail rates cover the cost to replace facilities?

A. No. The depreciation component currently included in retail rates generally covers a very small amount of the new facilities and equipment placed into service, especially for the long-lived assets. Avista's retail rates are cost-based, which means the prices customers are paying today for natural gas pipe, gate stations, transformers, distribution poles, substations, and transmission lines, among other facilities, are based on the cost to install those facilities, in some cases, 40, 50, and even 60 years ago. The costs of the same equipment and facilities today are many times more expensive. The depreciation component built into retail rates today is based on the much lower cost to install those facilities many years ago. Therefore, the depreciation component in retail rates <u>covers only a small fraction</u> of the annual costs associated with the new investment in facilities.

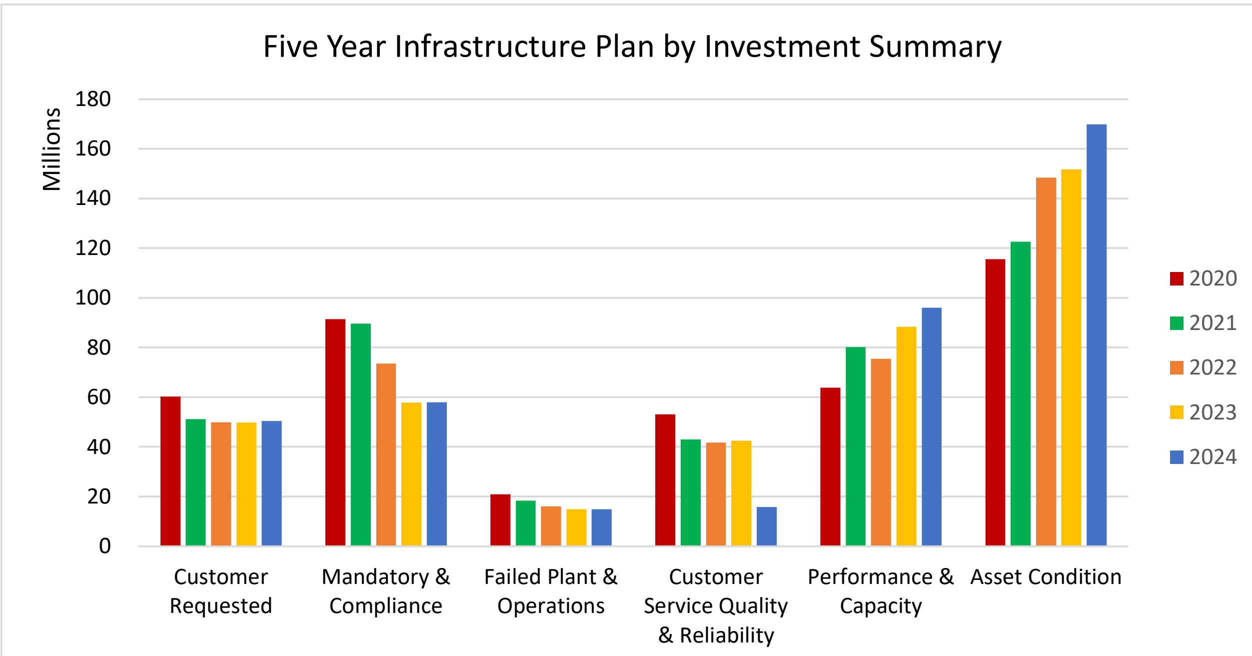
Q. How does Avista identify and prioritize its capital investments?

A. Avista's capital investments originate from the following six major "investment drivers":

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

An explanation of each of these drivers, as well as examples of specific capital projects under these drivers, is provided in the Infrastructure Investment Plan, attached as Exh. MTT-4. In addition, Company witnesses Mr. Thackston, Ms. Rosentrater, and Mr. Kensok provide details on the specific capital projects planned and in progress, why the projects need to be done in the time frame they will be completed, as well as what the risks and consequences are of not completing the projects.[2] A breakdown of planned investments for each driver for 2020-2024 is shown in Illustration No. 2 below.

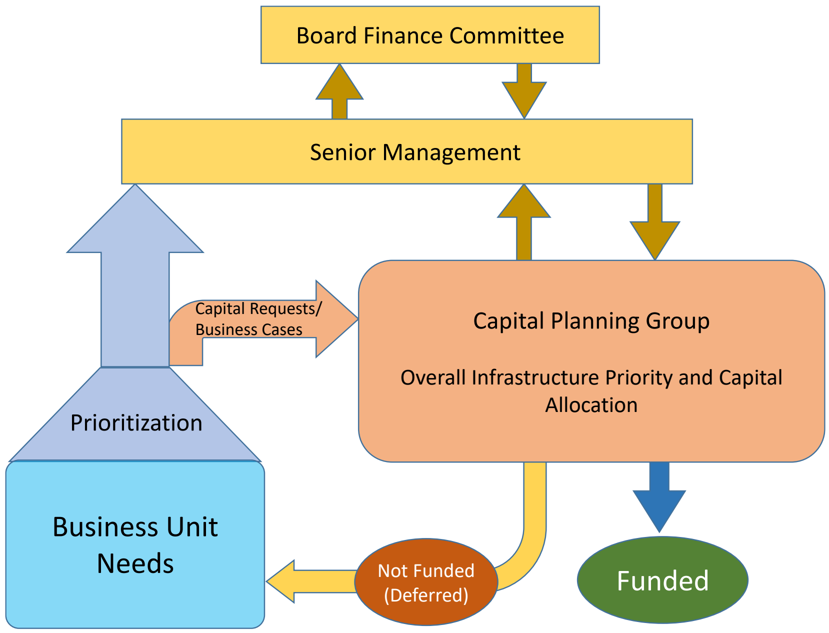
<u>Illustration No. 2 – Planned Investments by Capital Investment Driver (2020-2024)</u>



The process under which Avista's planned capital expenditures are identified and prioritized is illustrated in Illustration No. 3 below.

[2] Mr. Kinney, Mr. Howell and Mr. Magalsky discuss the Company's investments in EIM, Wildfire, and Customer Facing Technology, respectively.

<u>Illustration No. 3 - Identification and Prioritization Process</u>



The capital projects are identified in the lower-left portion of the diagram labeled "Business Unit Needs," and are then <u>prioritized within each department</u>. This prioritization occurs with the knowledge of the continuing constraint on the capital spend level for the Company, while at the same time the leadership of each department informs Senior Management of both the near-term and longer-term needs that are being delayed. For the prioritized projects, Business Cases[3] are developed for each of the Capital Requests that go to the Capital Planning Group (CPG) (as illustrated in the diagram). The CPG <u>prioritizes the Capital Requests across departments</u>, such that the overall planned capital spend stays within the constrained spend level established by Senior Management. The highest priority Capital Requests are "Funded", and a portion of the Capital Requests are "Not Funded" (Deferred),

[3] A Business Case is a summary document that defines the business problem addressed by a project or program, along with a proposal and recommended solution. The Business Case explains why the work is necessary, and the risks associated with not making the investment, as well as the alternatives considered, the selected alternative and the timeline associated with the project.

as shown on the diagram. Each year, the Board Finance Committee reviews and approves the first year of the rolling five-year capital investment plan. Under this Identification and Prioritization Process, the capital projects are screened and prioritized twice; once within the departments, and then a second time across departments within the CPG. This Identification and Prioritization Process is explained in more detail in the Infrastructure Investment Plan in Exh. MTT-4.

Q. What does Avista consider in setting the overall level of capital investment each year?

A. A range of factors influences the level of capital investment made each year, including: 1) the level of investment needed to meet safety, service and reliability objectives and to further optimize our facilities; 2) the degree of overall rate pressure faced by our customers; 3) the variability of investments required for major projects; 4) unanticipated capital requirements, such as an unplanned outage on a large generating unit; 5) the cost of debt; and 6) the opportunity to issue equity on reasonable terms.

Q. Why did the Company increase the level of its capital expenditures beginning in 2015?

A. The primary drivers that have affected Avista's level of capital investment includes the business need to fund a greater portion of the departmental requests for new capital investment that, in the past, have not been funded, and the need to capture investment opportunities and benefits identified by our asset management programs. It is important to note that the Company has held, and is projected to hold, the capital budget to an approximate $405 million level. What the Company is actively experiencing, as shown below, is increased funding stress. In additions to new required investment, using a flat level of capital, not adjusted for inflation, has also been problematic. For example, $405 million in 2017 is worth $432 million in 2020, and potentially close to $440 million in 2021. Not adjusting our level of capital additions for inflation has, in essence, actually limited our growth in capital additions.

Q. If a project is delayed for whatever reason, can the Company simply lower the capital budget for that year rather than find another project to fund?

A. The continuing progress on projects in the queue is very important to avoid the creation of a large "bow-wave" of investment that needs to be done in a relatively short period of time. Generally, if a project is delayed, moving the next priority project up helps to alleviate that bow-wave. This reprioritization occurs within the CPG, which is charged with ensuring that the total capital spend for the year stays within the constrained spending limit established by the Company. The dollar amount of capital projects requested by departments with the amounts approved by the Company is provided in Table No. 1 below. The dollar amounts for projects that were delayed (not approved) are also shown:

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

Year	Requested	Approved	Delayed	% Capital Delayed
2017	$461	$405	$56	**12%**
2018	$455	$405	$50	**11%**
2019	$528	$405	$123	**23%**
2020	$505	$405	$100	**20%**
2021	$477	$405	$72	**15%**
2022	$524	$405	$119	**23%**
2023	$463	$405	$58	**13%**
2024	$471	$405	$66	**14%**

As demonstrated in Table No. 1 above, the Company has a significant capital investment need, as determined by Company subject matter experts. If Avista were simply just trying to grow rate base for purposes of increasing earnings, we would not constrain ourselves to the $405 million capital budget level. Put another way, Avista could fully justify increasing its capital budget to $500 million over the next several years and reduce the obvious backlog of requested projects, but it is choosing not to in order to balance investment need with customer rate impact.

Q. What is driving the investment in utility plant in Washington?

A. As discussed in more detail by Company witness Ms. Andrews, the increase in overall costs to serve customers is driven primarily by the continuing need to replace and upgrade the facilities and technology we use every day to serve our customers, while revenue growth remains low. In particular, the Company's request includes the Company's electric and natural gas investment in AMI and related regulatory deferred balances, which will be completed early 2021, totaling of $92.2 million and $35.4 million, respectively. The Company has also included other major distinct electric projects related to the Company's Wildfire Plan and EIM[4] project totaling $22.5 million. In addition, the Company has pro formed certain gross plant additions for 2020 into the Company's electric and natural gas cases, totaling $130.6 million and $33.8 million, respectively. The revenue requirement requested in this case associated with these net capital additions alone, resulting from the increase in electric rate base of $245.3 million and natural gas rate base of $69.2 million, total $46.5 million electric and $12.0 million natural gas.[5]

[4] The capital addition for Wildfire and EIM include capital additions in 2020 and 2021. An additional amount of $7.6 million capital addition ($4.1 million on an AMA basis included in the case), planned to be in service in March 2022, was also included associated with the Company's investment in EIM because it is a short-lived five-year asset, as discussed by Mr. Kinney.

[5] The net impact of all other restating and pro forma adjustments, including the offset to electric requested revenue associated with the power supply reset, reduces the electric revenue request $2.3 million to $44.18 million, and increases natural gas $790,000 to $12.79 million.

Ms. Schultz sponsors the restating and pro forma capital adjustments which incorporate the effects of these capital investments in the determination of the Company's proposed revenue requirements. Other Company witnesses, (i.e., Mr. Thackston regarding production assets; Ms. Rosentrater regarding transmission, electric and natural gas distribution and general assets; Mr. Kensok regarding the costs associated with Avista's Information Service/Information Technology (IS/IT) projects; and Mr. Magalsky regarding investment related to Customer technology) provide more specific information on certain "major" capital projects during the historical periods 2018 and 2019, as well as certain 2020 pro forma capital projects included in this case, describing the need for and timing of these capital projects. These investments reflect, among other things, replacement and maintenance of Avista's utility system and to sustain reliability, safety, and service to customers. Major projects include recovery of Avista's Advanced Metering Infrastructure (AMI) program, Aldyl-A Pipe Replacement program, upgrades to the Company's generation resources, Distribution Grid Modernization, certain transmission and substation rebuilds, Enterprise & Control Network Infrastructure, Central Office Facility updates, and the overall systematic replacement of aging infrastructure, among others. Ms. Andrews sponsors the specific distinct project adjustments associated with AMI, EIM and Wildfire. While Mr. Howell discusses the Company's Wildfire Plan investments included for the period 2020 through 2021, Mr. Kinney discusses EIM investments included for the period 2020 through 2022, and Mr. Magalsky discusses the Company's Customer Facing Technology projects included for the period 2020 only.

IV. MATURING DEBT

Q. How is Avista affected by maturing debt obligations in the next five years?

A. In the next five years, the Company is obligated to repay maturing long-term debt totaling $315.5 million as shown in Table No. 2 below. Within this forward-looking five-year period, a large concentration – $250 million – matures within the second quarter of 2022.

Table No. 2

Avista Corp Long-Term Debt Maturities, 2020-2024				
Maturity Year	Principal Amount	Coupon Rate	Date Issued	Maturity Date
2020	$ 52,000,000	3.890%	12/20/2010	12/20/2020
2021	-	-	-	-
2022	$ 250,000,000	5.125%	9/22/2009	4/1/2020
2023	$ 5,500,000	7.530%	5/6/1993	5/5/2023
	$ 1,000,000	7.540%	5/7/1993	5/5/2023
	$ 7,000,000	7.180%	8/12/1993	8/11/2023
2024	$ -	-	-	-
Total	$ 315,500,000			

These debt obligations originated as early as 1993 and their original terms were between 10 and 30 years. These maturing obligations represent 17 percent of the Company's long-term debt outstanding at the end of 2019, which is a significant portion of our capital structure. It will be necessary for Avista to be in a favorable financial position to complete the expected debt refunding under reasonable terms, while also obtaining debt and equity to fund capital expenditures each year.

Q. What are the Company's expected long-term debt issuances through 2024?

A. To provide adequate funding for the significant capital expenditures noted in Section III above and to repay maturing long-term debt, we are forecasting the issuance of long-term debt in each year through 2024. We issued $165 million in 2020. Issuances planned for 2021 through 2024 are provided in Confidential Exh. MTT-5C.

Q. Has Avista considered recalling of debt to take advantage of current low long-term interest rates?

A. Yes. However, the recall provisions of debt issued require penalties (make-whole provisions) that exceed the value gained from current market interest rates. As discussed later in my testimony, Avista has an Interest Rate Risk Management Plan for issuance of long-term debt that includes hedging a portion of future issuance through interest rate swaps.

Q. Are there other debt obligations that the Company must consider?

A. Yes. In addition to long-term debt, the Company's $400 million revolving credit facility expires in April 2022. The Company had planned to renew and replace the facility in the spring of 2020 for a 5-year term, but due to the impacts of COVID-19 on the financial markets, the market conditions and pricing was such that it was not fiscally prudent to commit to a long-term, 5-year credit facility. Instead, the Company amended and extended the current facility for a term of 1-year, with an option to extend for one additional year. The Company relies on this credit facility to provide, among other things, funding to cover daily and month-to-month variations in cash flows, interim funding for capital expenditures, and credit support in the form of cash and letters of credit that are required for energy resources commitments and other contractual obligations.

The Company expects to initiate the renewal or replacement of the credit facility before the existing arrangement expires. Any outstanding balances borrowed under the revolving credit facility become due and payable when the facility expires. A strong financial position will be necessary to gain access to a new or renewed revolving credit facility, under reasonable terms, prior to expiration of the existing facility.

Additionally, the Company entered into a 364-day $100 million short-term credit agreement in April 2020, to provide additional liquidity as a result of COVID-19. The Company has borrowed the entire $100 million available under this credit agreement.

V. PROPOSED CAPITAL STRUCTURE AND COST OF CAPITAL

Q. What capital structure and rate of return does the Company request in this proceeding?

A. Our proposed capital structure is 50 percent debt and 50 percent equity, with a proposed cost of debt of 4.97 percent, a proposed 9.9 percent return on equity (ROE), and a requested overall rate of return (ROR) in this proceeding of 7.43 percent, as shown in Table No. 3 below.[6] The proposed capital structure for the One-Year Rate Plan is calculated excluding short-term debt.

Table No. 3

AVISTA CORPORATION
Proposed Cost of Capital
December 31, 2020

		Amount	Percent of Total Capital	Cost	Component Cost
Total Debt	$	1,973,500,000	50%	4.97%	2.48%
Common Equity	$	1,954,410,000	50%	9.90% (1)	4.95%
Total	$	3,927,910,000	100%		**7.43%**

[6] The calculations of the proposed capital structure (excluding short-term debt), cost of debt and overall cost of capital are provided with Exh. MTT-2. The calculation of the cost of debt includes $100 million of short-term debt.

Q. Why is Avista proposing to exclude short-term debt from the capital structure calculation in this case?

A. As explained by Mr. Vermillion and Ms. Andrews, the results from the Electric and Natural Gas Pro Forma Studies will not yield the rate relief necessary to provide the Company the opportunity to earn the proposed ROR requested in this case. One of the rate making "tools" identified by this Commission that can be used to arrive at an end result that provides sufficient revenues is the use of an adjusted capital structure.[7] Both Idaho and Oregon currently use this ratemaking tool of adjusting the capital structure by excluding short-term debt from the calculation. Avista's currently approved capital structure in Idaho and Oregon includes 50 percent equity and 50 percent debt. In this case Avista is proposing a similar adjustment to its capital structure, excluding short-term debt from the calculation. The calculation of the proposed capital structure is provided at page 6 of Exh. MTT-2.

Q. Why is the Company planning to maintain an equity ratio at this level?

A. Maintaining a 50 percent common equity ratio, excluding short-term debt, has several benefits for customers. We are dependent on raising funds in capital markets throughout all business cycles. These cycles include times of contraction and expansion. A solid financial profile will assist us in accessing debt capital markets on reasonable terms in both favorable financial markets and when there are disruptions in the financial markets.

Additionally, this common equity ratio solidifies our current credit ratings and moves us closer to our long-term goal of moving our corporate credit rating from BBB to BBB+. A

[7] The WUTC acknowledged at page 181 of its Order 08 in Docket No. UE-111048 and UG-111049 of Puget Sound Energy's rate proceeding, the consideration of adjustments to rate base beyond the historical test period by stating they were open to considering "Use of plant accounts (rate base) measured at the end, or subsequent to the end of the test-year rather than the test-year average," and their openness to consider <u>an "upward adjustment to the equity share in the capital structure</u>." (emphasis added)

rating of BBB+ would be consistent with the natural gas and electric industry average, which I will further explain later in my testimony. We rely on credit ratings in order to access capital markets on reasonable terms. Moving further away from non-investment grade (BB+) provides more stability for the Company, which is also beneficial for customers. We believe the proposed 50 percent equity appropriately balances safety and economy for customers.

Q. Would acceptance of the proposed 50/50 capital structure send a positive signal to rating agencies, and position Avista for a possible future rating upgrade?

A. I believe so. One of the conditions that led to the Moody's Investor Service downgrade in December 2018 was that the "Baa2 rating also looks at Avista's less predictable regulatory outcomes in Washington, where the Company generates about 60% of its revenue. Although the state has some credit supportive mechanisms, such as revenue decoupling, the use of historic test years results in the need file general rate cases more frequently."[8] They later state that a "rating upgrade could be considered with a demonstrated improvement in regulatory relationships."[9] Additionally, they recently stated, "a demonstrated improvement in regulatory environment and relationship will remain a key rating driver"[10], as a factor that could lead to a rating upgrade. In our view, approval of the proposed 50/50 capital structure could, assist us in moving further away from non-investment grade.

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

A. A key component of a continued long-term sound financial profile is the ability to receive timely recovery of capital additions and expenses, so the Company can earn its

[8] Moody's Investors Service, "Moody's Downgrades Avista Corp. to Baa2, Outlook Stable", Dec. 20, 2018, p. 1
[9] Id., p. 2
[10] Moody's Investor Service, Credit Opinion, July 2020.

authorized return. When regulatory mechanisms do not respond to changing cost factors, the level of return can move substantially below the authorized level. This creates financial weakness and concern in financial markets about the long-term stability of the Company.

Both Moody's and S&P cite the regulatory environment in which a regulated utility operates as the dominant qualitative factor to determine a company's creditworthiness. Moody's rating methodology is based on four primary factors. Two of those factors – a utility's "regulatory framework" and its "ability to recover costs and earn returns" – make up 50 percent of Moody's rating methodology[11]. In addition, S&P stated[12]:

> 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.

Q. How have the rating agencies viewed recent legislation in Washington that could provide for more constructive regulatory outcomes?

A. Moody's states the following[13]:

> Although Avista has experienced some relatively contentious proceedings in the past, we expect regulatory outcomes to become more predictable over time because of the May 2019 passage of a new clean energy bill in Washington. The bill is credit positive for Avista because it clarifies the WUTC's authority to consider and implement various constructive regulatory mechanisms including multiyear rate plans and performance and incentive-based regulation.

[11] Moody's Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, June 23, 2017.
[12] Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.
[13] Moody's Investor Service, Credit Opinion, July 2020.

S&P states the following[14]:

> There is potential improvement to Avista's business risk, despite a history of regulatory lag. Although Avista is currently experiencing a period of regulatory lag, we expect the 2019 passage of a law in Washington State to be favorable for its credit quality. The law allows for the authority for the Washington Utilities and Transportation Commission (WUTC) to approve multiyear rate plans and allow recovery for some utility investments deemed useful up to 48 months after the rate approval.
>
> We could lower our ratings on Avista during the next two years if adverse regulatory decisions weaken FFO to debt consistently below 14%, without sufficient countermeasures. We could also lower the ratings if Avista shifts its strategic focus to other business activities that weaken its credit quality.

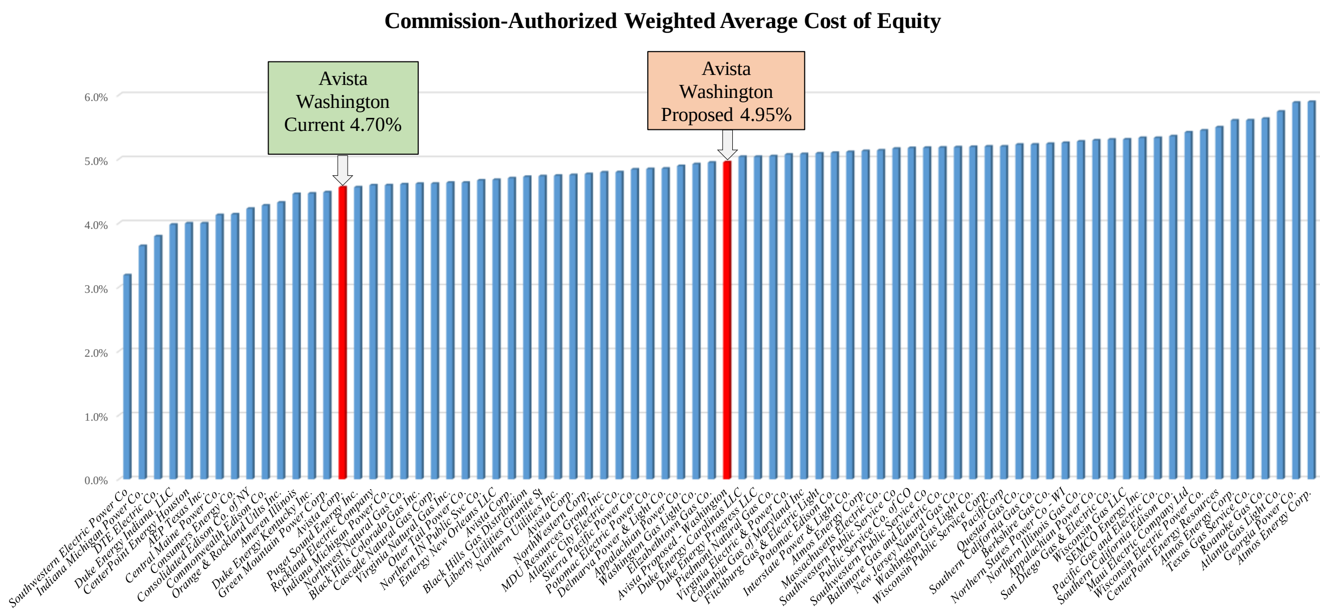
They also indicated that a key risk is the minimal cushion in the credit metrics at the current rating level and that they expect regulatory lag to persist until 2023. Because of the major capital expenditures planned by Avista and future maturities of long-term debt, a supportive regulatory environment is essential in maintaining our current credit rating.

Q. How does the Company's weighted average cost of equity compare to other utilities in the United States?

A. As shown in Illustration No. 4, Avista proposed weighted average cost of equity is in-line with other utilities authorized weighted average cost of equity, and that our present weighted average cost of equity is at the low end of actual, commission-authorized values:

[14] Standard and Poor's, Credit Opinion, May 2020.

<u>Illustration No. 4 – Commission-Authorized Weighted Average Cost of Equity</u>



Source: S&P Global, *RRA Regulatory Focus, Major Rate Case Decisions, January 2019-August 2020* (August 27, 2020).
Weighted Cost of Equity = Authorized Return on Equity * Common Equity to Total Capital.
Excludes decision that did not specify both an ROE and a common equity ratio, where the capital structure contains cost-free items or tax credit balances, and duplicate cases.

If the Commission simply carries over our existing ROE of 9.4 percent and 48.5 percent equity component, the weighted cost of equity would only be 4.7 percent, well below even the midpoint of Illustration No. 4 above. In fact, Avista's proposed weighted cost of equity puts very close to the midpoint.

Q. In attracting capital under reasonable terms, is it necessary to attract capital from both debt and equity investors?

A. Yes, it is absolutely essential. As a publicly traded company we have two primary sources of external capital: debt and equity investors. As of December 31, 2019, we had approximately $3.8 billion of long-term debt and equity. Approximately half of our capital structure is funded by debt holders, and the other half is funded by equity investors and retained earnings. Rating agencies and potential debt investors place significant emphasis on maintaining credit metrics and credit ratings that support access to debt capital markets under reasonable terms. Leverage – or the extent that a company uses debt in lieu of equity in its capital structure – is a key credit metric and, therefore, access to equity capital markets is critically important to long-term debt investors. This emphasis on financial metrics and credit ratings is shared by equity investors who also focus on cash flows, capital structure and liquidity, much like debt investors.

The level of common equity in our capital structure can have a direct impact on investors' decisions. A balanced capital structure allows us access to both debt and equity markets under reasonable terms, on a sustainable basis. Being able to choose among a variety of financing methods at any given time also allows the Company to take advantage of better choices that may prevail as the relative advantages of debt or equity markets can ebb and flow at different times.

Q. Are the debt and equity markets competitive markets?

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 equal to or better than investors' other alternatives. We are competing with not only other utilities but also with businesses in other sectors of the economy. Demand for our stock supports our stock price, which provides us the opportunity to issue additional shares under reasonable terms to fund necessary capital investments.

Q. What is Avista doing to attract equity investment?

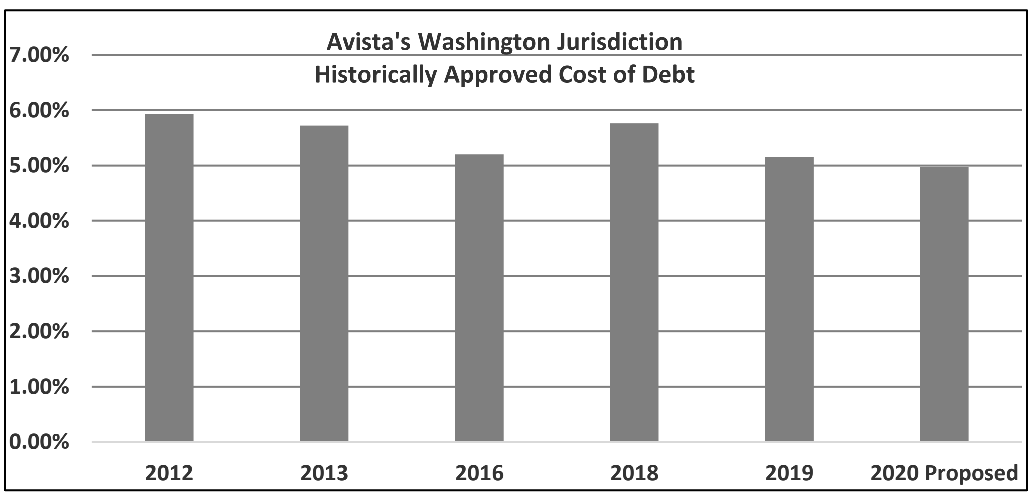
A. We are requesting a capital structure that provides us the opportunity to have financial metrics that offer a risk/reward proposition that is competitive and/or attractive for equity holders. We have steadily increased our dividend for common shareholders over the past several years, which is an essential element in providing a competitive risk/reward opportunity for equity investors.

Tracking mechanisms, such as the Decoupling Mechanisms, the Energy Recovery Mechanism and the Purchased Gas Adjustment approved by the regulatory commissions, help 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.

Q. What is the Company's overall proposed cost of debt, and how does it compare to its historically-approved cost?

A. Our requested overall cost of debt is 4.97%. The authorized cost of debt has trended downward for Avista from 2010 to 2020, with an exception of an uptick in 2018 due to low-cost debt that rolled off in 2016, as shown in Illustration No. 5 below.

<u>Illustration No. 5:</u>



Q. Please explain why Avista's cost of long-term debt is trending down.

A. There has been a general decline in interest rates over the past decade. At the same time Avista has issued new debt to fund capital expenditures and to replace higher cost debt maturing, which has caused the Company's overall cost of debt to decrease. We have been prudently managing our interest rate risk in anticipation of these periodic debt issuances, which has involved fixed rate long-term debt with varying maturities and executing forward starting interest rate swaps to mitigate interest rate risk on a portion of the future maturing debt and our overall forecasted debt issuances.

There was a decrease in the cost of debt for 2020, as compared to 2019 authorized, due in part to the maturation of $90 million of debt with an average coupon of 5.45% and an effective yield of 6.462% during 2019.

From 2014 through 2019 the Company issued $980 million in long-term debt. The weighted average interest rate of these issuances is 3.95%. These issuances have varying maturities ranging from 30 years to 35 years. Our most recent issuance was funded on September 30, 2020. This issuance of $165 million of first mortgage bonds with a thirty-year maturity was completed at a coupon rate of 3.07%. On the same day as the debt was priced, $70 million of interest rate swaps were settled. These swaps were entered into in accordance with the Company's Interest Rate Risk Management Plan (discussed in more detail later in my testimony), in order to reduce concentration risk associated with a single issuance date. The effective cost of this debt is 4.326%, including the issuance costs and the cost of settled interest rate hedges.

We have continued to take advantage of historically low rates. The Company's credit ratings have supported reasonable demand for Avista debt by potential investors. We have further enhanced credit quality and reduced interest cost by issuing debt that is secured by first mortgage bonds.

Q. What is the Company doing to mitigate interest rate risk related to future long-term debt issuances?

A. Our future borrowing requirements are primarily driven by our significant capital expenditure program and maturing debt, which creates exposure to interest rate risk. As mentioned earlier, we have approximately $2.0 billion in forecasted capital expenditures over the next five years. Additionally, we have $315.5 million of debt maturing during the same period. We are forecasting the issuance of approximately $795 million in long-term debt from 2020 through 2024 to fund these capital expenditures and maturing debt while maintaining an appropriate capital structure.

We usually rely on short-term debt as interim financing for capital expenditures, with issuances of long-term debt in larger transactions approximately once a year. As a result, we access long-term debt capital markets on limited occasions, so our exposure to prevailing long-term interest rates can occur all at once rather than across market cycles. To mitigate interest rate risks, we hedge interest rates for a portion of forecasted debt issuances over several years leading up to the date we anticipate each issuance.

There are a number of factors that should be taken into consideration in choosing the term of new debt issuances. For example, in the current interest rate environment where the interest rate spread for 30-year and 10-year terms is relatively narrow (i.e. presently there is a low premium for 30-year debt versus 10-year debt), supports increased reliance on longer-term debt.

In addition, the average life of plant assets for Avista exceeds 30 years. A 30-year term for debt is a closer match to the average life of the underlying assets that are being financed. Decisions on the term of the debt are generally made closer to the time that new debt is issued. Based on information available today, although the Company will consider some amount of 10-year debt, the issuances will likely be heavily weighted toward a 30-year term, due in large part to the matching of the financing to the life of the assets being financed, and the narrow rate spread for 30-year vs 10-year terms.

Q. Does the Company have guidelines regarding its interest rate risk management?

A. Yes. The Company's "Interest Rate Risk Management Plan", attached as Confidential Exh. MTT-3C, is designed to provide a certain level of stability to future cash flows and the associated retail rates related to future interest rate variability. The Plan provides guidelines for hedging a portion of interest rate risk with financial derivative instruments. We settle these hedge transactions for cash simultaneously when a related new fixed-rate debt issuance is priced in the market. The settlement proceeds (which may be positive or negative) are amortized over the life of the new debt issuance.

The Interest Rate Risk Management Plan provides that hedge transactions are executed solely to reduce interest rate uncertainty on future debt that is included in the Company's five-year forecast. The hedge transactions do not involve speculation about the movement of future interest rates.

Q. Has the Commission previously opined on the Company's Interest Rate Risk Management Plan?

A. Yes. In Dockets UE-170485 and UG-170486, Commission Staff witness Mr. McGuire took issue with the Company's interest rate hedging practices, recommending that "certain hedging losses" should be eliminated from the Company's cost of debt, in essence proposing a disallowance of certain hedges.[15] The Commission rejected Staff's proposal in Order 07, stating:

> We accept Mr. Thies' assertions that the Company adhered to its Interest Rate Risk Management Plan operational guidelines. Mr. Thies appropriately notes the Plan was finalized in 2013 after consultation with Staff and has been included as an appendix to his testimony in each GRC since that time, with hedging settlements being included as part of the cost of capital calculations.[16]

Q. Did the Commission give guidance in as to how the Company should hedge interest rates in the future?

A. Yes. In Order 07, the Commission agreed with Mr. McGuire that "the Company is expected to apply to its interest rate hedges the risk mitigation approach as provided in the March 2016 [natural gas] policy statement."[17]

Q. Before discussing more recent changes to the Company's Interest Rate Risk Management Plan, were the hedges that are included in the Company's cost of debt in this filing consistent with the same hedging plan that the Company operated under in its last several general rate cases?

A. Yes. The hedges included in this filing were entered into a manner that is consistent with the Company's Interest Rate Risk Management Plan in effect in Dockets UE-170485 and UG-170486 and were approved by the Commission. The Company has executed interest rate swaps, for purposes of reducing interest rate risk for our customers as early as 2004 and has been fully transparent in communicating its interest rate hedging activities. The settlement values, either losses or gains, of the interest rate swaps have been clearly included as a component of cost of debt in previous filings and this filing.

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[15] Docket Nos. UE-170485 and UG-170486, Order 07, ¶90.
[16] Id. ¶91.
[17] Id. ¶92.

Q. Has the Company made any changes to the Interest Rate Risk Management Plan?

A. Yes. After the issuance of the "Policy and Interpretive Statement on Local Distribution Companies' Natural Gas Hedging Practices" (Policy Statement) in Docket UG-132019 related to natural gas hedging, Avista has instituted natural gas risk responsive hedging. Since the issuance of the Policy Statement, Avista developed and tested a "Risk Responsive Hedging Tool" which integrates the use of Value at Risk analysis for natural gas hedging purposes. As a direct result of that work on the natural gas side, on January, 1, 2019, the Company added a Risk Responsive Hedging component to its existing Interest Rate Risk Management Plan. The most current Interest Rate Risk Management Plan has been included as Exh. MTT-3.

The interest rate Risk Responsive Hedging component employs Value at Risk (VaR) calculations to further monitor and respond to dramatic interest rate volatility for unhedged forecasted debt issuances. Risk Responsive Hedging is in effect for the two forward calendar year's debt issuances. In conjunction with implementing this new component, the Company reduced the Minimum Hedge Ratio for its existing Dynamic Window Hedging component to 40%. The Company believes that Risk Responsive Hedging is an additional protection for customers against extreme market swings associated with the interest rate market. Since the implementation, there have been no hedges executed under the Risk Responsive Hedging component.

Q. Turning now to return on equity ("ROE"), the Company is requesting a 9.9 percent ROE. Please explain why the Company believes this is reasonable.

A. We agree with the analyses presented by Mr. McKenzie which demonstrate that the proposed 9.9 percent ROE,[18] together with the proposed equity layer of 50 percent, would properly balance safety and economy for customers, provide Avista with an opportunity to earn a fair and reasonable return, and provide access to capital markets under reasonable terms and on a sustainable basis. Please see the direct testimony of Mr. McKenzie for his support of a 9.9 percent ROE.

VI. CREDIT RATINGS

Q. Please describe Avista's credit facility.

A. We have a credit facility in the amount of $400 million with a maturity date of April 18, 2022. The credit facility involves participation by eight banks. This credit facility was originally established in 2011, amended in April 2014, extended in May 2016 and then amended and extended in June 2020. Our credit facility provides the ability to take out or repay short-term debt based on day-to-day liquidity needs and to have letters of credit issued on the Company's behalf. The Company pays fees under three price elements in the agreement: 1) a facility fee to maintain the right to draw on the credit facility at any time, 2) interest on amounts borrowed, and 3) fees for letters of credit.

The Company may request letters of credit (LCs) underwritten by the participating banks and established for the benefit of counterparties to Avista. LCs are often used as collateral when required for energy resources forward commitments, forward swap transactions to hedge interest rate risk on future long-term debt, and other contractual or legal requirements that involve the Company. The maximum amount available for LCs is $150

[18] As stated by Mr. McKenzie, a 9.9 percent ROE is a conservative estimate of investors' required ROE for Avista.

million. The amount available for cash borrowing out of the overall $400 million credit facility is reduced by the amount of LCs outstanding. Table No. 4 below summarizes the rates paid to maintain and use the credit facility.

Table No. 4 – Credit Facility Fees (2020 Third Amendment to the 2011 Avista Corporation Credit Agreement)

Pricing Level	Facility Fee	Eurodollar Margin	ABR Margin	LC Participation Fee
I	0.125%	0.875%	0.000%	0.875%
II	0.150%	0.975%	0.000%	0.975%
III	0.175%	1.075%	0.075%	1.075%
IV	0.225%	1.150%	0.150%	1.150%
V	0.250%	1.250%	0.250%	1.250%
VI	0.300%	1.450%	0.450%	1.450%

The Pricing Level and associated rates that we are charged is based upon our underlying credit ratings as well as the security supporting the borrowings. Our current rates are based upon Pricing Level III, which became effective in December 2018 based on the Company's downgraded credit rating by Moody's. We achieve this Pricing Level by securing the credit facility with First Mortgage Bonds. If we did not secure this credit facility with First Mortgage Bonds, the costs would be based on Pricing Level IV, which would increase costs to customers. There are also upfront costs paid for setting up the credit facility (i.e. legal arrangement, bank commitments) that are amortized over the term of the credit facility.

Q. How important are credit ratings for Avista?

A. Utilities require ready access to capital markets in all types of economic environments. The capital-intensive nature of our business, with energy supply and delivery dependent on long-term projects to fulfill our obligation to serve customers, necessitates the ability to obtain funding from the financial markets under reasonable terms at regular intervals. In order to have this ability, investors need to understand the risks related to any of their investments. Financial commitments by our investors generally stretch for many years – even decades – and the potential for volatility in costs (arising from energy commodities, natural disasters and other causes) is a key concern to them. To help investors assess the creditworthiness of a company, nationally recognized statistical rating organizations (rating agencies) developed their own standardized ratings scales, otherwise known as credit ratings. These credit ratings indicate the creditworthiness of a company and assist investors in determining if they want to invest in a company and its comparative level of risk compared to other investment choices.

Q. Please summarize the credit ratings for Avista.

A. Avista' credit ratings, assigned by Standard & Poor's (S&P) and Moody's Investor Service (Moody's) are shown in Table No. 5 below:

<u>Table No. 5</u>

	S&P	Moody's
Senior Secured Debt	A-	A3
Senior Unsecured Debt	BBB	Baa2
Outlook	Stable	Stable

Additional information on our credit ratings has been provided on page 1 of Exh. MTT-2.

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

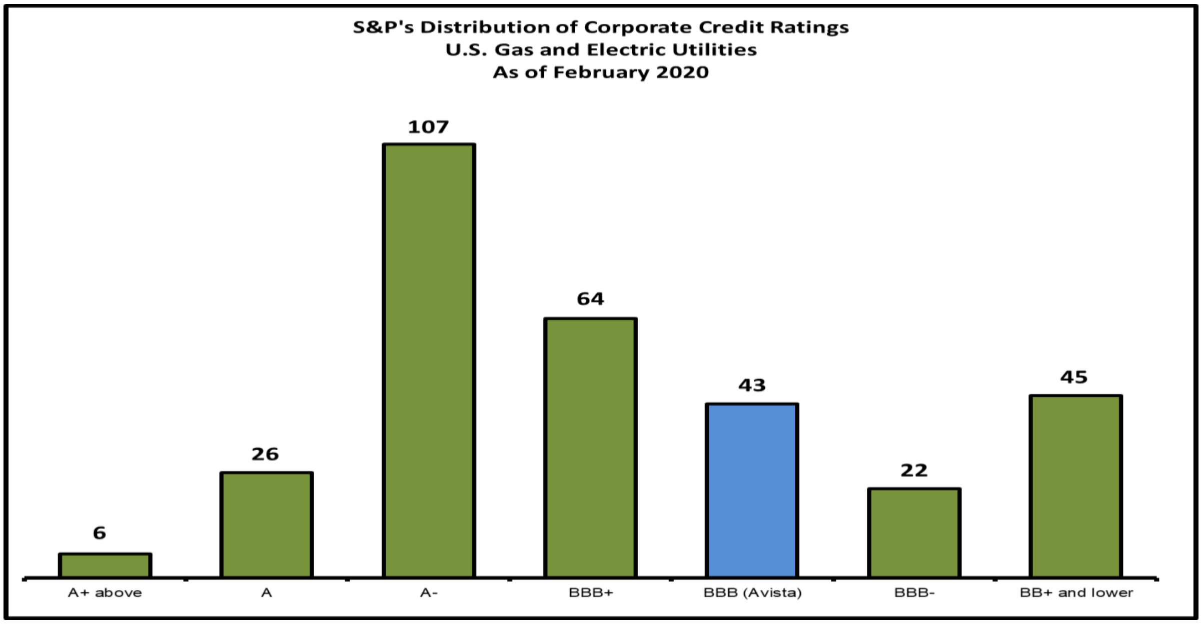
A. Credit ratings impact investor demand and expected returns. More specifically, when we issue debt, the credit rating can affect the determination of the interest rate at which the debt will be issued. The credit rating can also affect the type of investor who will be interested in purchasing the debt. 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 for payment of principal and interest in the event that the organization experiences severe financial stress. Investment risks include, but are not limited to, liquidity risk, market risk, operational risk, regulatory risk, and credit risk. These risks are considered by S&P, Moody's and investors in assessing our creditworthiness.

In challenging credit markets, where investors are less likely to buy corporate bonds (as opposed to U.S. Government bonds), a stronger credit rating will attract more investors, and a weaker credit rating could reduce or eliminate the number of potential investors. Thus, weaker credit ratings may result in a company having more difficulty accessing capital markets and/or incurring higher costs when accessing capital.

Q. What credit rating does Avista believe is appropriate?

A. Avista's current S&P corporate credit rating is BBB. We believe operating at a corporate credit rating level (senior unsecured) of BBB gives us the ability to continue to attract investors and to achieve competitive debt pricing. Although a corporate credit rating of BBB is a strong investment-grade credit rating, we continue to target a credit rating of BBB+ which is comparable with other US utilities providing both electricity and natural gas. As shown in Illustration No. 6, credit ratings for U.S. Regulated Combined Gas and Electric Utilities are highly concentrated at A- or BBB+.

Illustration No. 6



We expect that a continued focus on the regulated utility, conservative financing strategies and a supportive regulatory environment will contribute toward an upgrade to a BBB+ corporate credit rating for Avista. Operating with a BBB+ credit rating would likely attract additional investors, lower our debt pricing for future financings, and make us more competitive with other utilities. In addition, financially healthy utilities are better able to invest in the required infrastructure over time to serve their customers, and to withstand the challenges facing the industry and potential financial market disruptions.

Q. As discussed by Company witness Mr. Krasselt, the Company is proposing to offset the Company's base electric and natural gas rate relief requests with a "Tax Customer Credit."[19] Why is the Company proposing such a credit?

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[19] Mr. Krasselt explains that concurrent with the filing of this GRC, the Company has filed with this Commission its Tax Accounting Petition, requesting authorization to change its accounting for federal income tax expense from a normalization method to a flow-through method for certain plant basis adjustments, including Industry Director Directive No. 5 ("IDD #5") and meters (See Exh. RLK-1T for explanation). Approval of the Company's application would provide immediate benefits to customers, which the Company is requesting approval to defer,

A. The Company felt it was important to find ways to offset base rate increases for our customers during the COVID-19 pandemic. We realize that the Company's request to recover its costs in this case related to providing safe and reliable energy service would have an impact on our customers. As Mr. Vermillion discusses in his testimony, we understand that our customers have been impacted, and that we have sought to assist in a number of ways. This holds true for this case as well. We desired to find a way to mitigate our request – in effect deferring for a period of time the effects of this rate case on our customer's bills.

Q. Would you please provide more details on what the Company is proposing in this regard?

A. Yes. Based on the proposed Washington deferred tax benefit available, and the base rate increases proposed in this case, the Company is proposing to offset the electric base increase by amortizing the tax benefit through electric Schedule 76, effective October 1, 2021 through February 28, 2023, approximately one-and-one-quarter (1¼) years, fully amortizing the balance of $58.1 million as provided by Mr. Krasselt. For natural gas customers, the deferred tax benefit balance is $28.2 million. This balance allows an offset of the natural gas base increase of $12.8 million over two years ($25.6 million) through natural gas Schedule 176, amortizing the $25.6 million balance from October 1, 2021 through September 30, 2023, with a balance remaining for a future amortization.

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and to begin amortization through separate tariff of those benefits, concurrent with the effective date of this GRC.

Q. Will the proposed "Tax Customer Credit" have an effect on the Company's rating agency metrics?

A. Yes. The "Tax Customer Credit" will reduce the Company's cash flow and weaken the credit metrics tracked by the rating agencies. As noted earlier, S&P indicated that a key risk is the minimal cushion in the credit metrics at the current rating level. Weaker credit metrics will increase the risk of a ratings downgrade, which is why we are proposing to return to customers these tax benefits through separate "Tax Customer Credit" Schedules 76 (electric) and 176 (natural gas), to offset the customer base rate increases, as described earlier. But, with the proposed amortization periods, we believe that the Rating Agencies will take that into account when they review our metrics - that we are proposing essentially a one-time credit, and that the metrics will improve after amortization.

Q. Would it be wise for the Company or the Commission to amortize even more funds to customers at this time?

A. In short, no. The Company's proposal is balancing a fine line between investment-grade metrics and customer offsets. Due to the potential impact on the Company's cash flow metrics, the Company requests that, regardless of the electric and natural gas base revenue increases approved in this case, the electric and natural gas tax benefit amortization does not go beyond that approved on an annual basis, and does not go beyond a two year amortization period. As noted above, currently the Company's credit rating is at BBB, two notches above "non-investment grade" rating levels. A downgrade to our ratings to one-notch above or to non-investment grade, could be possible if the Commission were to include a higher amortization balance than the approved rate increases. That is true as well if the Commission went beyond the two-year amortization period proposed in this filing (as we believe the Rating Agencies will want to see those metrics revert to where they were in short order).

Any remaining balance, plus the on-going, incremental, annual deferred tax benefit recorded, would be included in future rate proceedings, and amortized over a 10-year period going forward. We believe this proposal properly balances the rate impact to customers and the Company's financial health. Applying more of the Tax Customer Credit beyond that proposed by the Company, will lower our credit metrics to a level that could cause a downgrade in our ratings. This would be negative to customers and could result in the Company having more difficulty accessing capital markets and/or incurring higher costs when accessing capital.

Q. How is the COVID-19 global pandemic currently affecting the business?

A. The COVID-19 global pandemic is currently impacting all aspects of our business, as well as the global, national and local economies. It is likely that the continued spread of COVID-19 and efforts to contain the virus will continue to cause an economic slowdown and possibly a recession, resulting in significant disruptions in various public, commercial or industrial activities. These circumstances have affected and will likely continue to adversely affect our operations, results of operations, financial condition and cash flows. Additionally, Moody's states:

> We expect Avista and its subsidiaries to be resilient to recessionary pressures related to the coronavirus because of its primary rate regulated, essential service business model and cost recovery framework. Nevertheless, we are watching for electric usage declines, utility bill payment delinquency and the regulatory response to counter these effects on earnings and cash flow.

Mr. Vermillion in his testimony provides details on how the Company has responded to the pandemic, on behalf of our customers. That includes the Tax Customer Credit which will help offset the Company's requested base rate relief.

Q. Does this conclude your pre-filed direct testimony?

A. Yes.