

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-14\_\_\_\_\_

DOCKET NO. UG-14\_\_\_\_\_

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

**I. INTRODUCTION**

1  
2 **Q. Please state your name, business address, and present position with Avista**  
3 **Corporation.**

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

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

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

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

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

2           A.     I will provide a financial overview of Avista Corporation as well as explain the  
3 proposed capital structure, overall rate of return, and our credit ratings. Additionally, I will  
4 summarize our capital expenditures program. Mr. Adrien McKenzie, on behalf of Avista, will  
5 provide additional testimony related to the appropriate return on equity for Avista, based on our  
6 specific circumstances, together with the current state of the financial markets.

7           In brief, I will provide information that shows:

- 8           • Avista’s plans call for making significant utility capital investments in generation,  
9 transmission and distribution systems to preserve and enhance service reliability for our  
10 customers and replace aging infrastructure. Capital expenditures of \$686 million are  
11 planned for 2014-2015. Capital expenditures of approximately \$1.7 billion are planned  
12 for the five-year period ending December 31, 2018. Avista needs adequate cash flow  
13 from operations to fund these requirements, together with access to capital from external  
14 sources under reasonable terms, on a sustainable basis.
- 15
- 16           • We are proposing an overall rate of return of 7.71 percent, which includes a 49.0 percent  
17 common equity ratio, a 10.1 percent return on equity, and a cost of debt of 5.42 percent.  
18 We believe our proposed overall rate of return of 7.71 percent and proposed capital  
19 structure provide a reasonable balance between safety and economy.
- 20
- 21           • Avista’s corporate credit rating from Standard & Poor’s (S&P) is currently BBB and  
22 Baa2 from Moody’s Investors Service (Moody’s)<sup>1</sup>. Avista must operate at a level that  
23 will support a solid investment grade corporate credit rating in order to access capital  
24 markets at reasonable rates. A supportive regulatory environment is an important  
25 consideration by the rating agencies when reviewing Avista. Maintaining solid credit  
26 metrics and credit ratings will also help support a stock price necessary to issue equity  
27 under reasonable terms to fund capital requirements.

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<sup>1</sup> On January 30, 2014, Moody’s upgraded Avista Corporation to Baa1, with a rating outlook of Stable.

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

2	<u>Description</u>	<u>Page</u>
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10

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

12 A. Yes. I am sponsoring Exhibit No. \_\_\_\_ (MTT-2) pages 1 through 6, which were  
 13 prepared under my direction. Avista's credit ratings by S&P and Moody's are summarized on  
 14 page 1, and Avista's actual capital structure at June 30, 2013, and proposed capital structure at  
 15 December 31, 2014, are included on page 2, with supporting information on pages 3 through 6.  
 16 Confidential Exhibit No. \_\_\_\_ (MTT-3C) includes our Interest Rate Risk Management Plan, and  
 17 Exhibit No. \_\_\_\_ (MTT-4) includes the equity ratios and returns on equity approved by various  
 18 state regulatory commissions from July 1, 2013, through January 11, 2014. Confidential Exhibit  
 19 No. \_\_\_\_ (MTT-5C) includes the Company's planned capital expenditures and long-term debt  
 20 issuances by year.

21

1 **II. FINANCIAL OVERVIEW**

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

3 A. We are operating the business efficiently to keep costs as low as practicable for  
4 our customers, while at the same time ensuring that our energy service is reliable, and customer  
5 demands are met. An efficient, well-run business is not only important to our customers, but  
6 also to investors. Additionally, we are working through regulatory processes to recover our costs  
7 in a timely manner so that earned returns are closer to those allowed by regulators in each of the  
8 states we serve. This is one of the key determinants from the rating agencies' standpoint when  
9 they are reviewing our overall credit ratings.

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

11 A. We are working to assure there are adequate funds for operations, capital  
12 expenditures and debt maturities. We obtain a portion of these funds through the issuance of  
13 long-term debt and common equity. We actively manage risks related to the issuance of both  
14 long-term debt and equity. These efforts include, but are not limited to, interest rate risk  
15 mitigation efforts and issuing common stock on a regular basis.

16  
17 **III. CAPITAL EXPENDITURES**

18 **Q. What has been the recent history of the Company's capital investment**  
19 **program?**

20 A. We are making significant capital investments in electric generation, transmission  
21 and distribution facilities, and in our natural gas distribution system to better serve the needs of

1 our customers. These investments target the preservation and enhancement of safety, service  
2 reliability, and the replacement of aging infrastructure. For the period 2010 through 2013, our  
3 capital expenditures totaled \$1.012 billion, for an average annual investment of \$253 million.  
4 While there is natural variation in the functional areas targeted for investment each year, the  
5 predominant areas have included electric generation and transmission and distribution facilities,  
6 natural gas distribution plant, new customer connects, environmental and regulatory  
7 requirements, and information technology and other supporting functions, such as fleet services  
8 and facilities.

9 **Q. In general, has the overall level of capital investment during these years**  
10 **(2010 – 2013) matched the annual capital requests submitted by the Company’s various**  
11 **departments?**

12 A. No. As Mr. DeFelice explains in his testimony, Avista has a Capital Planning  
13 Group that meets on a regular basis to review and prioritize all proposed utility capital  
14 investment projects. In recent years Avista has chosen to not fund all of the capital investment  
15 projects proposed by the various departments in the Company; driven primarily by the  
16 Company’s desire to mitigate the retail rate impacts to customers. The decision to delay funding  
17 certain projects was made only in cases where the Company believed the amount of risk  
18 associated with the delay was reasonable and prudent.

19

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

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

9           **Q.     What are the Company's current and future plans related to its capital**  
10 **expenditure program?**

11          A.     Compared with the recent past, as described above, we made the decision in 2013  
12 to increase our overall level of capital investment. Going forward, our five-year capital plan  
13 includes \$331 million for 2014, \$355 million for 2015, and \$350 million for each of the years  
14 2016 through 2018.

15          **Q.     Why is the Company increasing the level of its capital expenditures?**

16          A.     There are three primary drivers of the need to increase Avista's level of capital  
17 investment, including: 1) the business need to fund a greater portion of the departmental requests  
18 for new capital investments that in the past have not been funded; 2) the need to capture  
19 investment opportunities and benefits identified by our asset management capabilities, and 3) a  
20 continued focus on controlling the increase in operation and maintenance (O&M) spending  
21 through prudent capital investment.

1           **Q.     Can you provide some examples that illustrate the key drivers?**

2           A.     Yes. An example of the increase in capital investments identified through our  
3 continuing asset management discipline is in the replacement of aging electric transmission  
4 facilities. Programs such as this help increase levels of service reliability, improve the safety of  
5 our facilities, and reduce the life-cycle costs paid by our customers. Additional examples include  
6 Avista's Priority Aldyl A pipe replacement program, and the systematic rebuilding of electric  
7 distribution feeders.

8           One of the principal goals of asset management is to optimally manage risk and asset  
9 performance relative to capital investment and maintenance costs. Benefits of asset management  
10 include improved safety and reliability, improved life-cycle costs, and controlling the increase in  
11 O&M spending.

12           **Q.     Are there other reasons Avista believes the timing of this increase in capital**  
13 **spending is appropriate?**

14           A.     Yes. Interest rates remain near all-time lows, and funding them now will result in  
15 a lower long-term cost to customers, versus waiting until interest rates and inflation rise. In  
16 addition, Avista currently does not have a need for new capacity and energy resources, or new  
17 renewable resources, which would otherwise put upward pressure on retail rates. Furthermore,  
18 electric and natural gas commodity costs continue to be relatively stable as compared to past  
19 years, and are expected to remain relatively stable for the near future.



1 Funding the additional needed capital investment projects now will result in lower overall  
 2 bill impacts to customers rather than waiting until a time when retail rates are being driven  
 3 higher by increasing commodity costs, construction of new capacity and energy resources, and/or  
 4 higher inflation and interest rates.

5  
 6 **IV. CAPITAL STRUCTURE**

7 **Q. What is the capital structure and rate of return the Company is requesting in**  
 8 **this proceeding?**

9 A. Our requested capital structure is 51.0 percent total debt and 49.0 percent equity  
 10 with a requested overall rate of return in this proceeding of 7.71 percent, as shown in Illustration  
 11 No. 1 below. The requested capital structure is based on our forecasted capital structure at  
 12 December 31, 2014.

13 **Illustration No. 1**

<b>AVISTA CORPORATION</b>			
<b>Proposed Cost of Capital</b>			
<b>December 31, 2014</b>			
	<u>Percent of</u>	<u>Cost</u>	<u>Component</u>
	<u>Total Capital</u>		<u>Cost</u>
Total Debt	51.0%	5.42%	2.76%
Common Equity	49.0%	10.10%	4.95%
Total	<u>100%</u>		<u>7.71%</u>

1           **Q.     Is the capital structure reflected in Illustration No. 1 above, calculated in a**  
2 **manner similar to the capital structure calculated in Avista's recent rate proceedings?**

3           A.     Yes. This methodology removes debt outstanding at our unregulated business as  
4 well as the impact of costs related to the issuance of equity. We have included a short-term debt  
5 balance of \$100 million, which represents approximately 3.22 percent of our overall capital  
6 structure. The \$100 million in short-term debt represents the forecasted average during 2015  
7 (the period when rates would become effective).

8           **Q.     How does the Company determine the amount of long-term debt, short-term**  
9 **debt and common equity to be included in its capital structure?**

10          A.     As a regulated utility, Avista has an obligation to provide safe, and reliable  
11 service to customers while balancing safety and economy. Through our planning process, we  
12 determine the amount of new financings needed to support our capital expenditure programs  
13 while maintaining an optimal capital structure that balances and supports our current credit  
14 ratings.

15          **Q.     What are the Company's expected long-term debt issuances through 2018?**

16          A.     Due to significant capital expenditures noted in Section III above and maturing  
17 long-term debt, we are forecasting the issuance of long-term debt in each year through 2018.  
18 We plan to issue \$100 million in 2014. Issuances planned for 2015 through 2018 are provided in  
19 confidential Exhibit No. (MTT-5C).

1           **Q.     Why is the Company proposing a 49 percent equity ratio?**

2           A.     Avista's financing plans include a 49 percent equity ratio during the 2015 rate  
3 year. Maintaining a 49 percent common equity ratio has several benefits for customers. We are  
4 dependent on raising funds in capital markets throughout all business cycles. These cycles  
5 include times of contraction and expansion. Lower leverage implies lower financial risk of a  
6 company. This implied reduced risk will assist us in accessing capital markets on reasonable  
7 terms when there are disruptions in the financial markets.

8           Additionally, a 49 percent common equity ratio solidifies our current credit ratings and  
9 moves us closer to our long-term goal of having a corporate credit rating of BBB+. A rating of  
10 BBB+ would be consistent with the natural gas and electric industry average, which I will further  
11 explain later in my testimony. We rely on credit ratings in order to access capital markets on  
12 reasonable terms. Moving further away from non-investment grade (BB+) provides more  
13 stability for the Company, which is also beneficial for customers. We believe our requested 49  
14 percent equity appropriately balances safety and economy for customers.

15           In addition, because there is a relationship between the equity ratio and the return on  
16 equity (ROE), later in my testimony I will also address the reasonableness of the proposed 49  
17 percent equity ratio in combination with the proposed 10.1 percent ROE.

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

3           A.     Yes, it is absolutely essential. As a publicly traded company we have two  
4 primary sources of external capital: debt and equity investors. As of June 30, 2013, we had  
5 approximately \$2.6 billion of debt and equity. Approximately half of our capital structure is  
6 funded by debt holders, and the other half is funded by equity investors and retained earnings.  
7 There tends to be significant emphasis on maintaining credit metrics and credit ratings that will  
8 provide access to debt capital markets under reasonable terms, however, access to equity capital  
9 markets is equally important. In fact, equity investors also focus on cash flows, capital structure  
10 and liquidity, much like debt investors. The level of common equity in our capital structure can  
11 have a direct impact on investors' decisions. A balanced capital structure allows us access to  
12 both debt and equity markets under reasonable terms, on a sustainable basis.

13           **Q.     Are the debt and equity markets competitive markets?**

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

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

2           A.     We are requesting a capital structure that provides us the opportunity to have  
3 financial metrics that offer a risk/reward proposition that is competitive and/or attractive for  
4 equity holders.

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

9           Tracking mechanisms, such as the Energy Recovery Mechanism and Purchased Gas  
10 Adjustment, approved by the regulatory commissions help balance the risk of owning and  
11 operating the business in a manner that places us in a position to offer a risk/reward opportunity  
12 that is competitive with not only other utilities, but with businesses in other sectors of the  
13 economy.

14

15

#### **V. PROPOSED RATE OF RETURN**

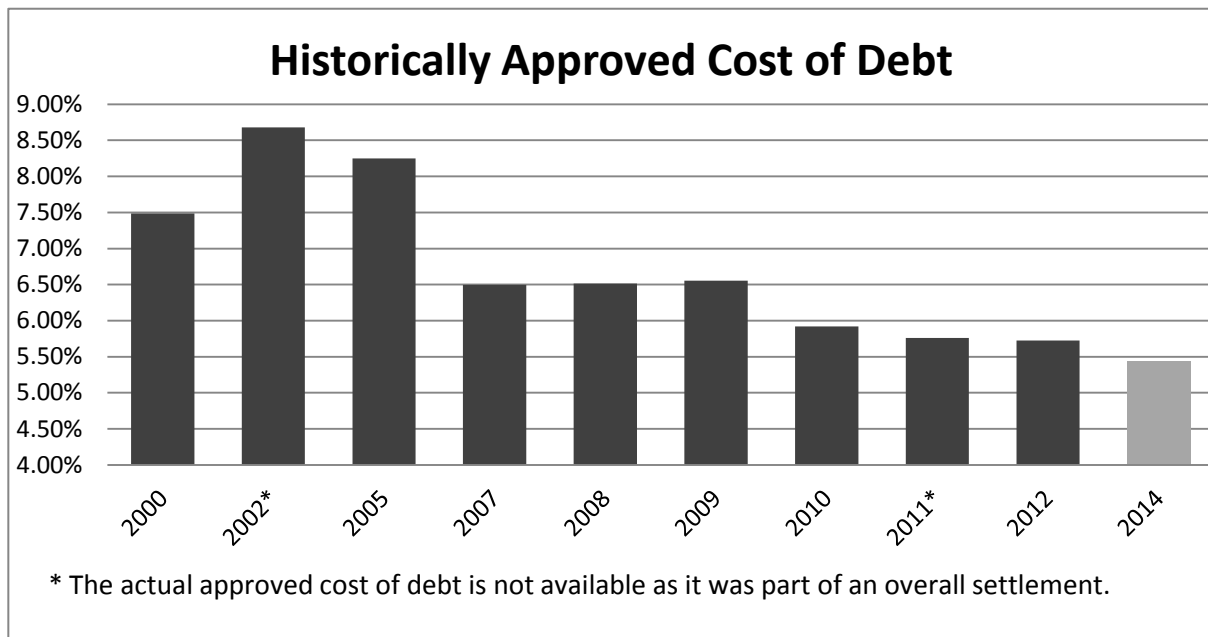
16           **Q.     Has Avista prepared an exhibit that includes the components of Avista's**  
17 **requested rate of return of 7.71 percent?**

18           A.     Yes. Exhibit No. \_\_\_\_ (MTT-2) shows the components of Avista's requested rate  
19 of return of 7.71 percent.

20           **Q.     What is the Company's overall cost of debt, and how does the Company's**  
21 **requested overall cost of debt compare to its historically-approved cost?**

1 A. Our requested overall cost of debt is 5.42 percent. This cost of debt is lower than  
 2 the Commission's historically approved cost of debt for Avista from 2000 to 2012. Illustration  
 3 No. 2 contains the Commission's approved cost of debt for Avista since 2000.

4 **Illustration No. 2**



13 **Q. Please explain why Avista's cost of long-term debt has continued to decrease.**

14 A. In addition to the overall decline in interest rates, we have been prudently  
 15 managing our interest rate risk, which has involved fixed rate long-term debt with varying  
 16 maturities, and executing forward starting interest rate swaps to mitigate interest rate risk.

17 For example, since December 2010 we have issued \$392 million in long-term debt. The  
 18 weighted average rate of these issuances is 3.25 percent. These issuances have varying  
 19 maturities, which ranged from 3 years to 35 years and resulted in a weighted average maturity of  
 20 approximately 19 years. Through these programs we have been able to lower the cost of debt  
 21 while extending our weighted average maturity.

1           Our most recent issuance (in 2013) was \$90 million of first mortgage bonds with a three  
2 year maturity at a rate of 0.84%. This new debt, which matures in 2016, refinanced \$50 million  
3 of three year debt that matured in 2013, carrying a rate of 1.68%. We have continued to issue  
4 debt with varying maturities to balance the cost of debt and the weighted average maturity. This  
5 has provided us with the ability to take advantage of historically low rates on both the short-end  
6 and long-end of the yield curve.

7           We plan on continuing to issue long-term debt with various maturities for the foreseeable  
8 future in order to fund our capital expenditure program and long-term debt maturities.

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

11           A.     Our future borrowing requirements are primarily driven by our significant capital  
12 expenditure program and maturing debt, which creates exposure to interest rate risk. As  
13 mentioned earlier, we have \$1.7 billion in forecasted capital expenditures over the next five  
14 years. Additionally, we have \$362.5 million of debt maturing during the same period. We are  
15 forecasting the issuance of \$955 million in long-term debt from 2014 through 2018 to fund these  
16 capital expenditures and maturing debt as well as to maintain an appropriate capital structure.

17           We manage this interest rate risk exposure by limiting outstanding debt with variable  
18 interest rates, issuing fixed rate long-term debt with varying maturities to manage the amount of  
19 debt that is required to be refinanced in any period, and executing forward starting interest rate  
20 swaps.

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

3           A. Yes. The Company's Interest Rate Risk Management Plan is attached as  
4 Confidential Exhibit No.\_\_\_\_(MTT-3C). The goal of this plan is to maintain a competitive cost  
5 of capital, while reducing cash flow volatility and the associated retail rate impacts related to  
6 future interest rate variability.

7           The following is a summary of major items this plan addresses:

- 8           • Managing interest rate exposure by limiting variable rate exposures to a percentage of  
9 total capitalization, through the use of fixed rate long-term debt with varying  
10 maturities, and hedging a portion of interest rate risk with financial derivative  
11 instruments;
- 12           • The utilization of hedge ratios, hedge windows, triggers, and rate monitoring;
- 13           • Forecasting, counterparty, credit, basis and termination risks;
- 14           • Authorized interest rate derivatives utilized to hedge interest rate risk; and
- 15           • The oversight provided by the Finance Committee of the Board, Risk Management  
16 Committee, and Treasury Management.

17  
18           Additionally, the plan provides that interest rate risk management occurs solely in the  
19 context of hedging underlying financial exposures associated with interest rate uncertainty.

20           **Q. Were there any forward-starting interest rate swap agreements settled**  
21 **related to the long-term debt issued in 2013?**

22           A. Yes. We cash settled two interest rate swap contracts (notional amount of \$85.0  
23 million) in conjunction with the pricing and issuance of a \$90.0 million term loan agreement that  
24 was completed in August 2013 and received a total of \$2.9 million. This amount has been  
25 included in the yield to maturity calculation for the \$90 million debt.



1 **Q. Please describe Avista's credit facility.**

2 A. We currently have a credit facility in the amount of \$400 million with a maturity  
3 date of February 2017. Illustration No. 3 contains a summary of the rates paid to maintain and  
4 use the credit facility:

5 **Illustration No. 3**

Pricing Level	Facility Fee	Eurodollar Margin	ABR Margin	LC Participation Fee
I	0.100%	0.775%	0.000%	0.775%
II	0.125%	0.875%	0.000%	0.875%
III	0.175%	0.950%	0.000%	0.950%
IV	0.200%	1.050%	0.050%	1.050%
V	0.250%	1.250%	0.250%	1.250%
VI	0.300%	1.450%	0.450%	1.450%

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12  
13  
14 The Pricing Level and associated rates that we are charged is based upon our underlying  
15 credit ratings. Our current rates are based upon Pricing Level II. We achieve this Pricing Level  
16 by securing the credit facility with First Mortgage Bonds. If we did not secure this credit facility  
17 with First Mortgage Bonds, the costs would be based on Pricing Level IV, which would increase  
18 costs to customers. There are also upfront costs paid for setting up the credit facility (i.e. legal  
19 arrangement, bank commitments) that are amortized over the term of the credit facility.

20 **Q. Is the cost of short-term debt the Company seeks to recover in this**  
21 **proceeding consistent with the approach in its most recent general rate case?**

1           A.     Yes, the calculated cost of short-term debt includes in the rates from the table  
2 above, amortization of upfront costs, and forecasted LIBOR rates. The result is a short-term debt  
3 cost of 3.04 percent, as shown in Exhibit No.\_\_\_\_(MTT-2) page 4.

4           **Q.     The Company is requesting a 10.1% return on equity. Please explain why the**  
5 **Company believes this is reasonable?**

6           A.     We agree with the analyses presented by Mr. McKenzie which demonstrates that  
7 the proposed 10.1 percent ROE would properly balance safety and economy for customers,  
8 provide Avista with an opportunity to earn a fair and reasonable return, and would provide  
9 access to capital markets under reasonable terms, and on a sustainable basis.

10          **Q.     Please explain the relationship between ROE and the equity ratio of the**  
11 **capital structure.**

12          A.     As the equity ratio decreases, it correspondingly increases our financial risk. As  
13 risk increases, our cost of equity should also increase in order to compensate investors for this  
14 implied additional financial risk. Avista is requesting a capital structure of 49 percent, and a  
15 10.1 percent ROE, resulting in a weighted ROE of 4.95 percent ( $0.49 \times 0.101$ ). If the  
16 Commission lowers our requested equity ratio, it should make a corresponding increase to our  
17 requested ROE to recognize the additional implied financial risk.

18          **Q.     How does Avista's requested 4.95 percent weighted cost of equity compare**  
19 **with the weighted cost of equity recently approved for electric and natural gas utilities in**  
20 **other jurisdictions?**

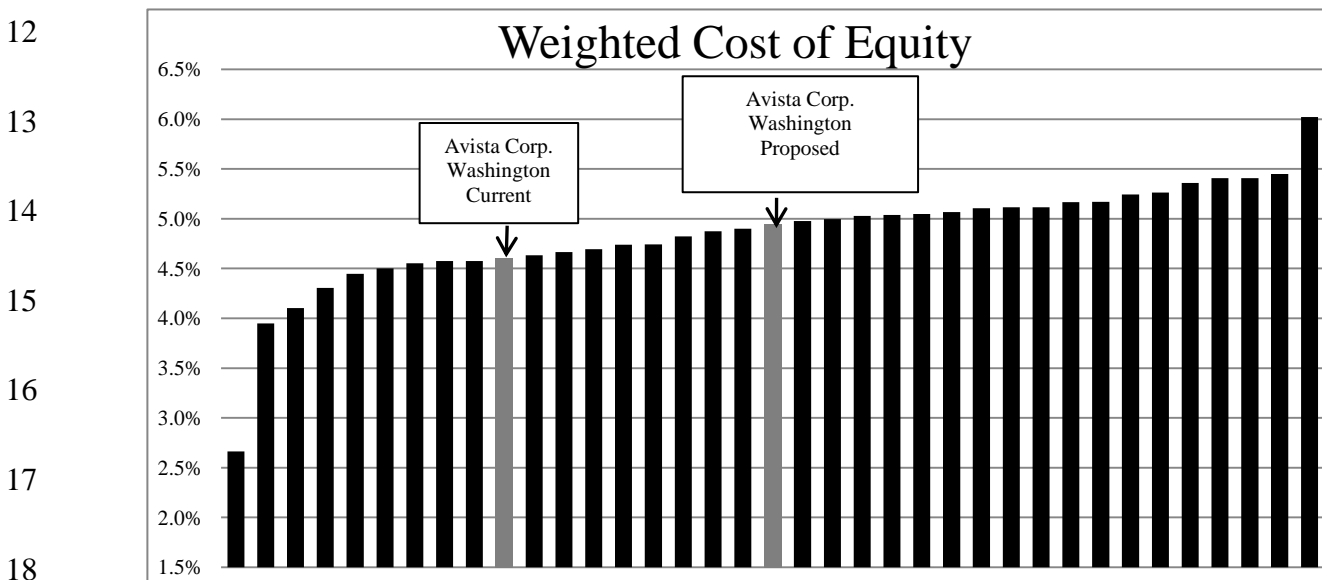
21          A.     The bar chart in Illustration No. 4 below shows the weighted cost of equity  
22 approved by state regulators for investor-owned utilities across the country, for the approximate

1 six-month period from July 1, 2013 through January 11, 2014. These data in the bar chart  
 2 represent all of the commission decisions that specify an ROE and equity ratio for utilities in the  
 3 most recent six-month period.

4 Avista’s proposed weighted cost of equity of 4.95 percent, which is also shown in the  
 5 chart, is right in the middle of the range of these weighted cost of equity numbers. Avista’s  
 6 current weighted cost of equity of 4.61 percent is also shown on the chart, which is based on a 47  
 7 percent equity ratio and a 9.8 percent ROE. Additional details related to this chart, including the  
 8 names of the utilities, are provided in Exhibit No. \_\_\_\_ (MTT-4).

9 Because Avista competes with other utilities for equity investor dollars, it is important for  
 10 Avista to have an earnings opportunity that is competitive with other utilities.

11 **Illustration No. 4<sup>2</sup>**



19

<sup>2</sup> Source – SNL Financial, Rate Cases finalized July 1, 2013 through January 11, 2014.

**VI. CREDIT RATINGS**

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

A. Utilities require 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 volatility in commodity costs, 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. To help investors assess the creditworthiness of a company, Nationally Recognized Statistical Rating Organizations (rating agencies) developed their own standardized ratings scale, 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.

**Q. Please summarize the credit ratings for Avista.**

A. Avista' credit ratings, assigned by S&P and Moody's are as follows:

	S&P	Moody's <sup>3</sup>
Senior Secured Debt	A-	A3
Senior Unsecured Debt	BBB	Baa2
Outlook	Stable	Positive

Additional information on our credit ratings has been provided on page 1 of Exhibit No. \_\_\_\_ (MTT-2).

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<sup>3</sup> On January 30, 2014, Moody's upgraded Avista Corporation to Baa1, with a rating outlook of Stable.

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

3           A.    Credit ratings impact investor demand and expected returns.  More specifically,  
4 when we issue debt, the credit rating can affect the determination of the interest rate at which the  
5 debt will be issued.  The credit rating can affect the type of investor who will be interested in  
6 purchasing the debt.  For each type of investment a potential investor could make, the investor  
7 looks at the quality of that investment in terms of the risk they are taking and the priority they  
8 would have for payment of principal and interest in the event that the organization experiences  
9 severe financial stress.  Investment risks include, but are not limited to, liquidity risk, market  
10 risk, operational risk, and credit risk.  These risks are considered by S&P, Moody’s and investors  
11 in assessing our creditworthiness.

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

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

18           A.    Avista believes operating at a corporate credit rating level of BBB+ is comparable  
19 with other US utilities providing both electricity and natural gas.  As shown in Illustration No. 5,  
20 the average credit rating for U.S. Regulated Combined Gas and Electric Utilities is BBB+.

1 **Illustration No. 5**

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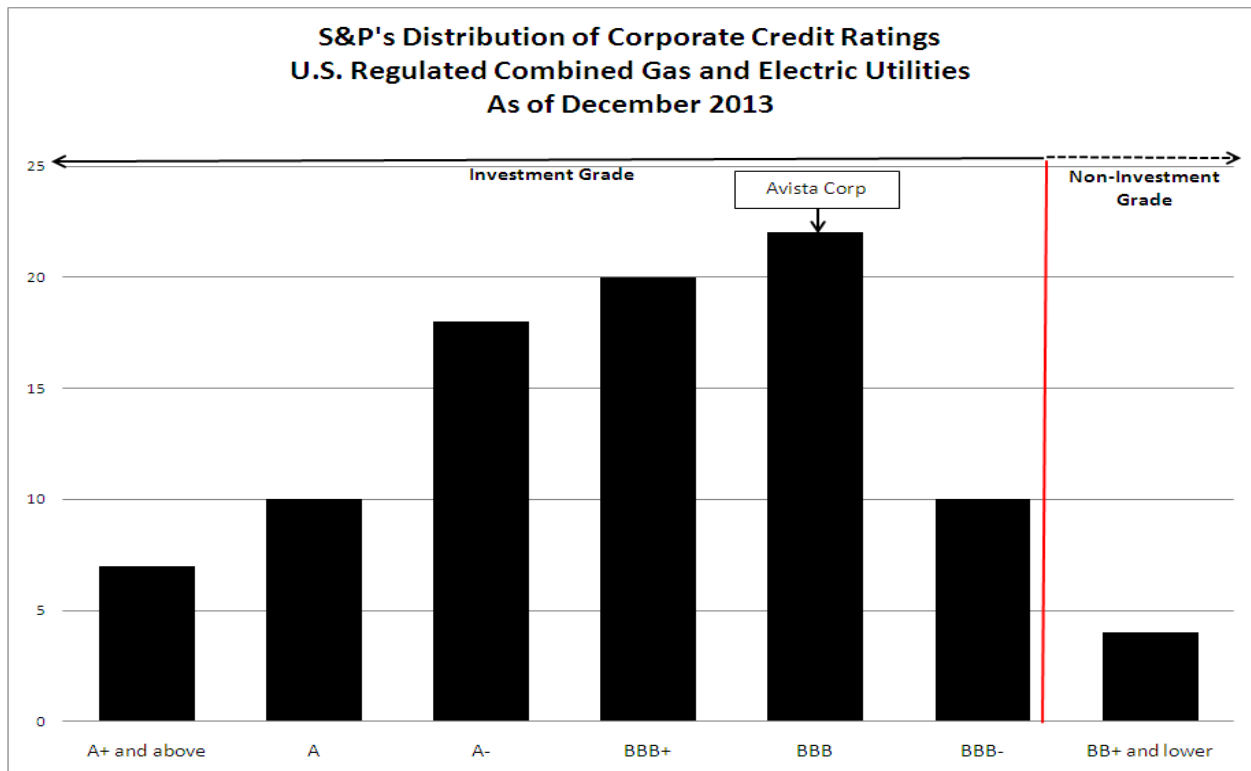
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We expect that a continued focus on the regulated utility, conservative financing strategies and a supportive regulatory environment will contribute toward an upgrade to a BBB+ credit rating. Operating at a BBB+ would likely attract additional investors, lower our debt pricing, 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 disruptions in the financial market.

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

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

5           Moody's rating methodology is based on four primary factors. Two of those factors: a  
6 utility’s “regulatory framework” and its “ability to recover costs and earn returns,” make up 50  
7 percent of Moody’s rating methodology.

8  
9 S&P states the following:

10  
11           Regulation is the most critical aspect that underlies regulated integrated utilities’  
12 creditworthiness. Regulatory decisions can profoundly affect financial  
13 performance. Our assessment of the regulatory environments in which a utility  
14 operates is guided by certain principles, most prominently consistency and  
15 predictability, as well as efficiency and timeliness. For a regulatory process to be  
16 considered supportive of credit quality, it must limit uncertainty in the recovery of  
17 a utility’s investment. They must also eliminate, or at least greatly reduce, the  
18 issue of rate-case lag, especially when a utility engages in a sizable capital  
19 expenditure program<sup>4</sup>.  
20

21           Due to the major capital expenditures planned by Avista and future maturities of long-  
22 term debt, a supportive regulatory environment is essential in maintaining our current credit  
23 rating.

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<sup>4</sup> Standard and Poor’s, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.

1 **VII. ALASKA ACQUISITION TRANSACTION**

2 **Q. On November 4, 2013, the Company announced it entered into an Agreement**  
3 **and Plan of Merger with Alaska Energy and Resources Company (AERC). How will the**  
4 **Company fund this transaction?**

5 A. The Company will initially fund this acquisition with the issuance of common  
6 stock. At the closing of the acquisition of AERC by Avista, the issued and outstanding shares of  
7 AERC common stock would be exchanged for shares of Avista common stock. The purchase  
8 price for AERC at closing is \$170 million, less the assumption of then-outstanding debt and  
9 other closing adjustments per the Merger Agreement. The value of Avista common stock to be  
10 issued in exchange for AERC common stock is estimated to be \$145 million. We expect the  
11 transaction to close on or before July 1, 2014.

12 Following the closing of the transaction, debt is planned to be issued at AEL&P and  
13 AERC to rebalance the capital structure. As part of the rebalancing of the capital structure at  
14 AEL&P and AERC, funds would be transferred from AERC to Avista, which would be used to  
15 fund the utility capital budget and utility operating costs at Avista. Therefore, a portion of the  
16 proceeds from the initial common equity issuance would ultimately be used to fund the utility  
17 capital budget and utility operating costs at Avista.

18 Additionally, upon completion of the merger, AERC would become a wholly-owned  
19 corporation of Avista. AEL&P, a vertically integrated electric utility providing electric service  
20 to the City and Borough of Juneau, would continue to be a wholly-owned corporation of AERC.  
21 The current debt outstanding at AEL&P is backed by the assets and equity of AEL&P. Avista  
22 would not be providing collateral or guarantees related to the current debt outstanding. If the



1 current debt outstanding at AEL&P is refinanced and/or additional debt is issued at AEL&P or  
2 AERC, it would be backed solely by the assets of AERC and/or AEL&P. Avista would not  
3 provide collateral or guarantees related to future debt issuances at AERC/AEL&P. As AERC &  
4 AEL&P would be separate legal entities and any debt outstanding at AERC or AEL&P would be  
5 backed solely by the assets of AERC and/or AEL&P, holders of their debt would have no  
6 recourse against Avista. The debt and equity of AERC would be excluded from the capital  
7 structure proposed in future Washington rate filings.

8 **Q. Do you have any closing observations?**

9 A. Yes, our initiatives to carefully manage our operating costs and capital  
10 expenditures are an important part of our performance, but are not sufficient without revenues  
11 from the general rate request for our electric and natural gas businesses in these cases. Sufficient  
12 cash flows from operations can only be achieved with the support of regulators in allowing the  
13 timely recovery of costs and the ability to earn a reasonable return.

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

15 A. Yes.