Exh. KJC-1T

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET UE-240006

DOCKET UG-240007

DIRECT TESTIMONY OF

KEVIN J. CHRISTIE

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

A. My name is Kevin Christie, and I am employed as the Senior Vice President, Chief Financial Officer, Treasurer and Regulatory Affairs Officer for Avista. My business address is 1411 East Mission Avenue, Spokane, Washington.

Q. Would you briefly describe your educational background and professional experience?

A. Yes. I graduated from Washington State University with a Bachelor of Business Administration degree with an accounting emphasis. I have also attended the University of Idaho Utility Executive Course, and the Finance for Senior Executives program at Harvard Business School. I joined the Company in 2005 as the Manager of Natural Gas Planning. In 2007, I was appointed the Director of Gas Supply, then in 2012 I was appointed as the Senior Director of Finance. In 2014 I was appointed to Senior Director of Customer Solutions, and in 2015 I was appointed Vice President of Customer Solutions. In 2019 I was promoted to Senior Vice President of External Affairs and Chief Customer Officer. I was promoted to my present position in May 2023.

Prior to joining Avista, I was employed by Gas Transmission Northwest (GTN). I was employed by GTN from 2001 to 2005 and was the Director of Pipeline Marketing and Development from 2003 to 2005 and the Director of Pricing and Business Analysis from 2001 to 2003. From 2000 to 2001, I was employed by PG&E Corporation (PG&E) as the Manager of Finance and Assistant to the SVP, Treasurer and CFO. Before joining PG&E, I was employed by Pacific Gas Transmission Company (PGT) from 1994 to 2000. While at PGT, I held several positions including Manager, Pricing and Business Analysis, Senior Business Analyst, and Senior Pricing Planner. From 1990 to 1994, I was employed by Chevron USA as a Lease Revenue Accountant.

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

A. I will provide a summary of our operating environment and 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, on a system basis, of $500 million (for 2024), $525 million (for 2025), and $575 million (for 2026) are planned over the term of the filing and rate effective dates for this rate plan. 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 7.61 percent, which includes a 48.5 percent common equity ratio, a 10.40 percent return on equity, and a cost of debt of 4.99 percent. We believe our proposed overall rate of return of 7.61 percent and the proposed capital structure provide a reasonable balance between affordability and reliability.

3. Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB with a <u>negative outlook</u> 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:

Description		Page
I.	Introduction	1
II.	Financial Overview	3
III.	Credit Ratings	9
IV.	Proposed Cost of Capital and Structure	14
V.	Capital Expenditures	21

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

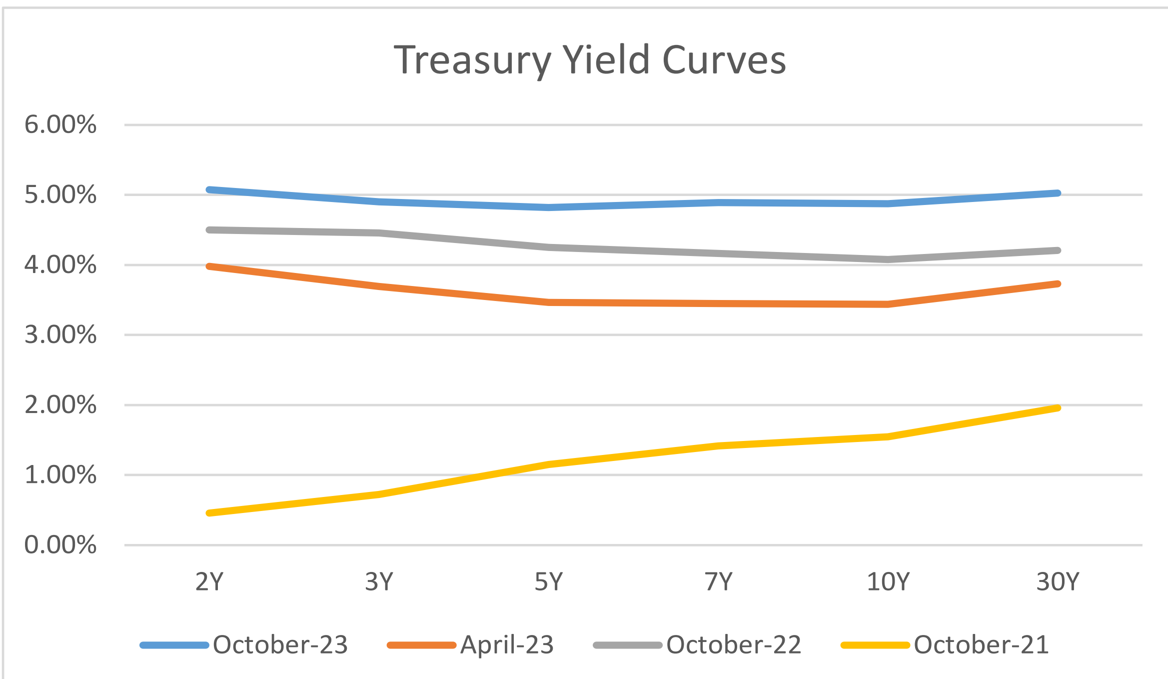
A. Yes. I am sponsoring Exh. KJC-2, pages 1 through 7, which was prepared under my direction. Avista's credit ratings by S&P and Moody's are summarized on page 1. Avista's proposed capital structure and cost of capital are included on page 2, with supporting information on pages 3 through 7. Confidential Exh. KJC-3C shows the Company's planned capital expenditures and long-term debt issuances by year for 2024-2027. I am also sponsoring Exh. KJC-4 which provides documents referenced in footnotes 2, 3 and 6.

II. FINANCIAL OVERVIEW

Q. How has the current state of the economy impacted Avista?

A. The post-pandemic operating environment has been challenging in several ways for Avista. First, inflationary pressures have significantly increased our operating costs, resource costs, and cost of materials. These pressures have amplified the lag experienced by the Company in terms of cost recovery, negatively impacting the expected return by investors. It has also put additional strain on our credit metrics which I'll discuss in more detail later in my testimony. Second, the Federal Reserve has continued to aggressively increase interest rates in an attempt to bring inflation down to their 2% target. Avista uses its credit facility to fund day to day operations, and as a result of the Federal Reserve's increase in rates, our borrowing rate has increased nearly <u>500 basis points in less than two years</u>. As you can see in Figure No. 1 below, the increase in interest rates has impacted all tenors along the Treasury yield curve, including the 30-year Treasury which is the benchmark we have used in recent years to price our long term debt. As discussed later in my testimony this has resulted in an increase in our overall cost of borrowing.

<u>Figure No. 1 – Treasury Yield Curves Oct. 2021 – Oct. 2023, Various Tenors</u>



Coupled with rising interest rates, the extreme volatility in the energy markets in late 2022 also negatively impacted Avista because it required the Company to post historically large amounts of cash collateral which put a significant strain on our liquidity. The Company borrowed on the credit facility to post the required collateral at higher cost than what is currently included in rates. While there are tracking mechanisms in place to partially mitigate the effects to financial results related to commodity costs, the Company's cash flows are impacted until those deferred costs are collected from customers in a subsequent period (i.e., we have needed to finance tens of millions of dollars at higher rates not seen in decades). In short, the Company has been exposed to higher interest expense associated with higher power supply and natural gas costs until they are recovered through the regulatory process. We continue to post elevated amounts of collateral due to volatility in the energy markets.

Another challenge of higher interest rates is the pressure it puts on our stock price. This isn't unique to Avista, as we have seen a downward trend in stock prices across the industry. Utility stocks are very attractive in low interest rate environments due to their traditionally high dividend yields and relative risk. More recently with higher interest rates, investors can obtain a higher return on debt instruments with a much lower risk profile. This added pressure is in addition to an increase in investor sensitivity to industry-related risks, especially wildfire risk for Avista.

To attract capital, the Company must provide a return that compensates investors for the risk associated with their investment. A lower stock price requires the Company to issue more shares to raise the same amount of capital. In recent months, the Company's stock price has traded <u>below book value</u> which prevented us from issuing equity. This creates added difficulty when trying to raise equity to fund our capital investments. The lower stock price has also put pressure on financial metrics requiring additional collateral being posted at times.

Over the last few years, the utility risk landscape has shifted dramatically, increasing the number of risks that the Company must address. One risk of primary focus has been wildfire risk. The credit rating agencies, investment analysts and debt and equity investors frequently inquire about wildfire risk. Inquiries have primarily revolved around operating practices, financial exposure, and insurance coverage related to wildfire liability. Wildfire risk impacts investors' decisions about whether to purchase debt and equity securities and can impact credit ratings that will ultimately impact the cost of capital.

Equity analysts have also heighted their scrutiny of authorized ROEs and regulatory outcomes. During our conversations with analysts, this is a topic frequently discussed. Authorized ROE is one of the primary factors participants in the equity capital markets will review when assessing the adequacy of the outcome of a general rate case for the purposes of making an investment decision. The expectations for the required return, and thus the cost of equity capital, have increased during this inflationary period.

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

A. As I highlighted in my introduction, the cost pressures from inflation and rising interest rates have negatively impacted Avista. Over the last two years, these cost headwinds have hurt Avista's financial performance. In addition, another major headwind impacting Avista's financial performance is higher resource costs as a result of poor hydro performance in 2023. The higher resource costs absorbed through the Energy Recovery Mechanism (ERM) is expected to reduce earnings significantly in 2023. Our financial performance has also negatively impacted investor and sell-side analyst sentiment, and in turn, our stock performance. Half of the sell-side analysts that provide investment research on the Company have a sell rating on Avista stock, Avista's stock has materially underperformed our peers and is among the worst in the utility sector with a return of negative 20.7% year-to-date through December 7th compared to the S&P 500 utility index at negative 10.7%.

As I discuss in more detail later, Standard and Poor's (S&P) has placed Avista's credit rating on "negative outlook" due to the expectation that Avista's weakening financial performance will cause our metrics to fall below their downgrade thresholds because of inflation, rising interest rates, and regulatory lag. The Company's weak financial performance, deterioration in credit metrics, and poor stock performance highlights again the challenging environment we are operating in and the importance of a supportive regulatory environment.

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 have the actual opportunity to earn its authorized return. When regulatory mechanisms do not respond to changing cost factors, the level of return can move substantially below the authorized level. The Company will be hard pressed to significantly cut costs without jeopardizing the quality and reliability of service; in fact our challenge will be to moderate the increases in costs in this difficult operating environment. The absence of timely cost recovery creates financial weakness and concern in financial markets about the long-term stability of the Company. The amount of regulatory lag the Company has experienced since our last case, is one of the reasons S&P revised our outlook to negative in November 2022.

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[2]. In addition, S&P stated[3]:

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

> 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.

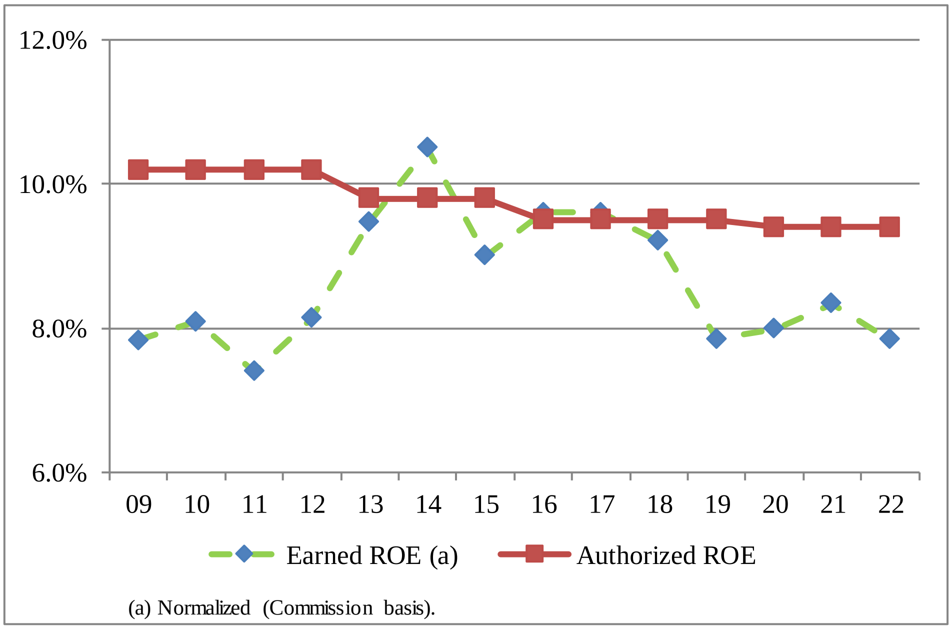
S&P also indicated[4] that a key risk is the minimal cushion in the credit metrics at the current rating level and that they expect the customer tax credits, regulatory lag and inflationary pressure to weaken financial measures for a year or two and that there is minimal cushion for financial underperformance. Because of the required major capital expenditures planned by Avista and future issuances of long-term debt, a supportive regulatory environment is essential in maintaining an investment grade credit rating.

Q. Has Avista continued to experience "earnings erosion," notwithstanding an approved two-year rate plan?

A. Yes, it has. Our actual (normalized) returns continue to lag well below the authorized levels. Figure No. 2 below, excerpted from Mr. McKenzie's testimony (Exh. AMM-1T, p. 21), shows actual versus authorized returns from 2009-2022, and but for a brief period (2014-2018) when an "attrition adjustment" was in place, our earnings are again lagging behind the authorized level.

[4] Standard and Poor's, Ratings Score Snapshot, August 2022.

<u>Figure No. 2 – Actual Vs. Authorized ROE</u>



III. CREDIT RATINGS

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. 1 below:

<u>Table No. 1 – Avista's Current Credit Ratings</u>

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

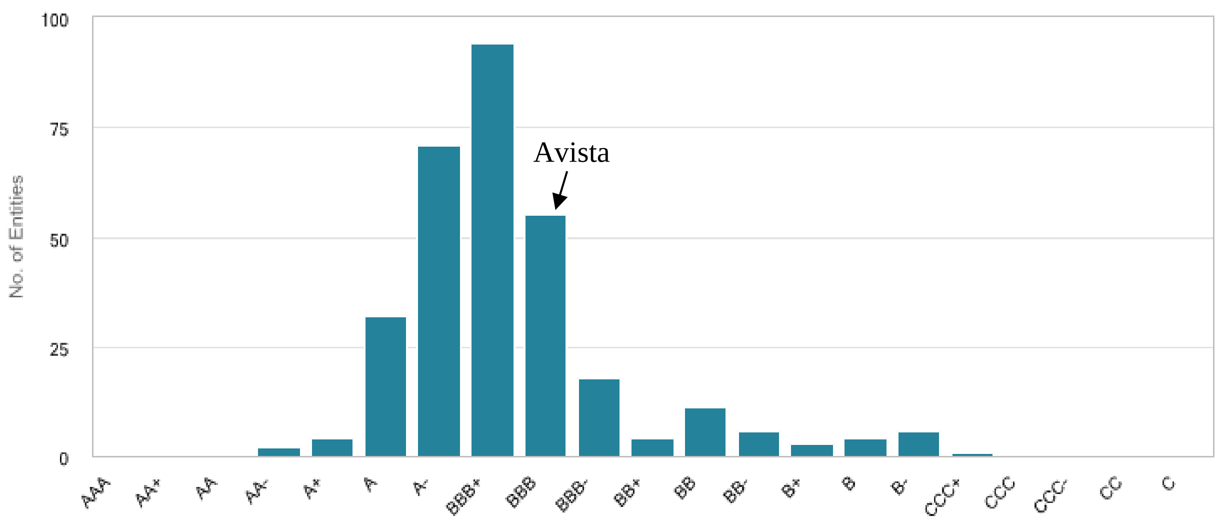
Additional information on our credit ratings has been provided on page 1 of Exh. KJC-2. The current economic environment also highlights the importance of our credit rating. In tight markets such as a recession, liquidity for companies that are below investment grade becomes extremely limited, resulting in lack of cash on reasonable terms to finance the business and fund capital projects needed to maintain reliability for our customers.

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. How do Avista's credit ratings compare with others in the industry, with whom Avista competes for capital?

A. Excerpted below is Figure 4 from Mr. McKenzie's testimony (Exh, AMM-1T, p. 28), comparing Avista's Corporate Credit Rating with other utilities. Moreover, S&P recently reported that of the 243 regulated utilities covered in its survey, only 19 had a weaker credit profile than Avista.

<u>Figure No. 3 – S&P Corporate Credit Ratings – Utilities (Excerpted from Exh. AMM-1T, Figure 4)</u>



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, firms such as S&P and Moody's 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. The credit rating can also affect the type of investor who will be interested in purchasing the debt. 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.

Q. Have cost pressures and regulatory lag negatively impacted Avista's credit ratings?

A. Yes. On November 11, 2022, S&P revised their outlook on Avista to negative from stable and affirmed our 'BBB' issuer credit rating and 'A-' rating on our senior secured debt. S&P states the following:[5]

> Inflation--which includes higher expenses, customer refunds, rising interest rates, and delayed recovery of purchased fuel costs--has contributed to the company's weakening financial measures. The negative outlook reflects our expectation for a weakening of financial performance below our downgrade threshold because of inflation, rising interest rates, and regulatory lag. We could lower our ratings on Avista over the next 12-24 months if adverse regulatory outcomes, regulatory lag, or rising expenses pressure the company's financial measures...

Q. Has S&P recently confirmed its negative outlook for Avista?

A. Yes, on December 8, 2023, S&P issued a "Ratings Score Snapshot" where it states that their "negative outlook reflects our expectation that Avista's weakening financial performance will cause its metrics to fall below our downgrade thresholds because of inflation, rising interest rates, and regulatory lag…We could lower our ratings on Avista over the next 12 to 24 months if ***adverse regulatory outcomes, regulatory lag, or rising expenses pressure its financial measures***." (emphasis added)[6]

Q. What might happen if Avista falls below investment grade?

A. If our credit ratings were to fall below investment grade, it would cause additional harm to the risk perception of the Company in the debt markets. Our borrowing costs would increase substantially. If the Company experiences a reduction in its credit rating the Company could be subject to requests by its wholesale energy counterparties to post additional collateral. In addition, counterparties to derivative instruments and other forward contracts could request immediate payment or demand full collateralization. A downgrade would immediately raise our cost of our short-term borrowing and would increase the cost for

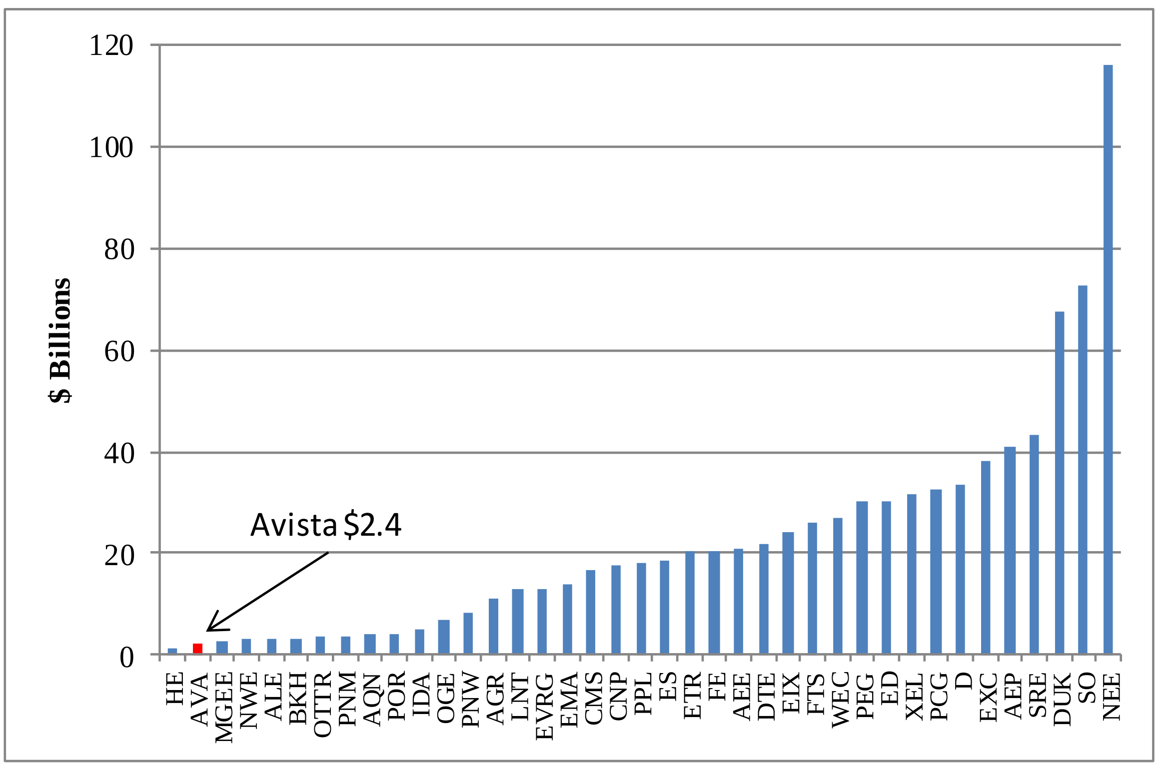
[5] "Avista Corp Outlook Revised to Negative on Weaker Financial Measures; Ratings Affirmed." https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2916024 (November 11, 2022).
[6] "Ratings Score Snapshot", Dec. 8, 2023, S&P Global.

future long-term borrowings. Given the current negative outlook from S&P, we are concerned an adverse regulatory outcome would put additional pressure on our financial metrics and most likely result in a downgrade in our credit rating. A downgrade would also negatively impact Avista's stock price, decreasing the value the Company would receive for issuances in the equity markets.

Q. In closing, how does Avista's small size contribute to its financial risk?

A. The only publicly traded utility smaller than Avista is Hawaiian Electric (HEI), excerpted from Mr. McKenzie's testimony, Figure 3 (Exh AMM-1T, p. 23).

Figure No. 4 – Comparison of Market Capitalization



Avista's market capitalization placement on the very low end of the industry, which affects it ability to withstand cost pressures and external risks beyond its control (e.g., wildfire risk and a fluctuating and highly variable (if not unstable) power market). And, as noted by Mr.

McKenzie, the only firm smaller than Avista is HEI, whose survival has been threatened by a lack of sufficient size and financial resources to absorb the risk of potential financial liabilities stemming from the Maui wildfires.

IV. PROPOSED COST OF CAPITAL AND STRUCTURE

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

A. Our proposed capital structure is 51.5 percent debt and 48.5 percent equity, with a proposed cost of debt of 4.99 percent, a proposed 10.40 percent return on equity (ROE), and a requested overall rate of return (ROR) in this proceeding of 7.61 percent, as shown in Table No. 2.

Table No. 2 – Proposed Cost of Capital

AVISTA CORPORATION
Proposed Cost of Capital
December 31, 2025

		Amount	Percent of Total Capital	Cost		Component Cost
Total Debt	$	2,743,700,000	51.5%	4.99%		2.57%
Common Equity	$	2,588,899,805	48.5%	10.40%	(1)	5.04%
Total	$	5,332,599,805	100.0%			**7.61%**

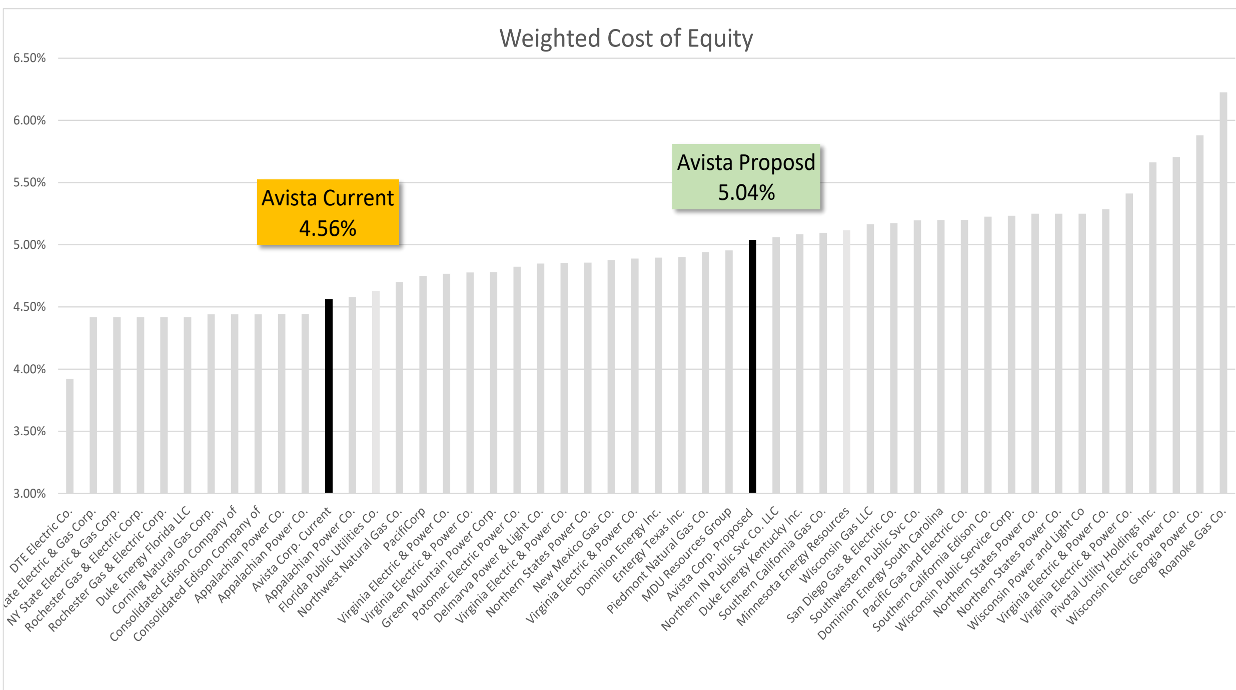
Q. Why is the Company proposing a 48.5 percent equity ratio?

A. Maintaining a 48.5 percent common equity ratio 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, a 48.5 percent common equity ratio solidifies our current credit ratings and moves us closer to our long-term goal of having a corporate credit rating of BBB+ and would be consistent with the natural gas and electric industry average. Moving further away from non-investment grade (BB+) provides more stability for the Company, which is also beneficial for customers.

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. 1, Avista's <u>proposed</u> weighted average cost of equity is in-line with other utilities <u>authorized</u> weighted average cost of equity, and that our present weighted average cost of equity is at the low end of actual, commission-authorized values:

<u>Illustration No. 1 – Commission-Authorized Weighted Average Cost of Equity (2021-2023)</u>



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 4.56 percent, well below even the midpoint (4.89%) and average (4.93%) of Illustration No. 1 above.

Q. The Company is requesting a 10.40 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 10.40 percent ROE is reasonable to maintain Avista's financial integrity, provide a return commensurate with investments of comparable risk, and support the Company's ability to attract capital. Please see the direct testimony of Mr. McKenzie (Exh AMM-1T) for his support of a 10.40 percent ROE.

Q. Does the Company incur flotation costs?

A. Yes, the Company incurs flotation costs when equity is issued. These flotation costs include services such as legal, accounting, and printing, as well as the fees and discounts paid to compensate brokers for selling the stock to the public. For example, for 2023, through September 30, the Company had incurred $1.3 million in flotation costs. These costs have ranged as high as $1.8 million in recent years. Flotation costs are not recorded on the income statement and are not included in the cost of capital. Common equity raised through the sale of stock is recorded net of these costs. There are opportunity costs associated with issuing equity and flotation costs that will be further discussed by Mr. McKenzie related to the overall cost of equity.

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 <u>external</u> capital: debt and equity investors. As of June 30, 2023, we had approximately $5.0 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.

As previously mentioned in my testimony, our metrics have been challenged since our last general rate case. Our outlook with S&P was revised from stable to negative in late 2022. Any further downgrades would cause additional harm to the risk perception of the Company in the debt and equity markets.

Q. Are the debt and equity markets competitive markets?

A. Yes, they are. 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. More recently, we are now competing essentially with the risk-free treasury rate, which has made utility dividends less attractive. 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?

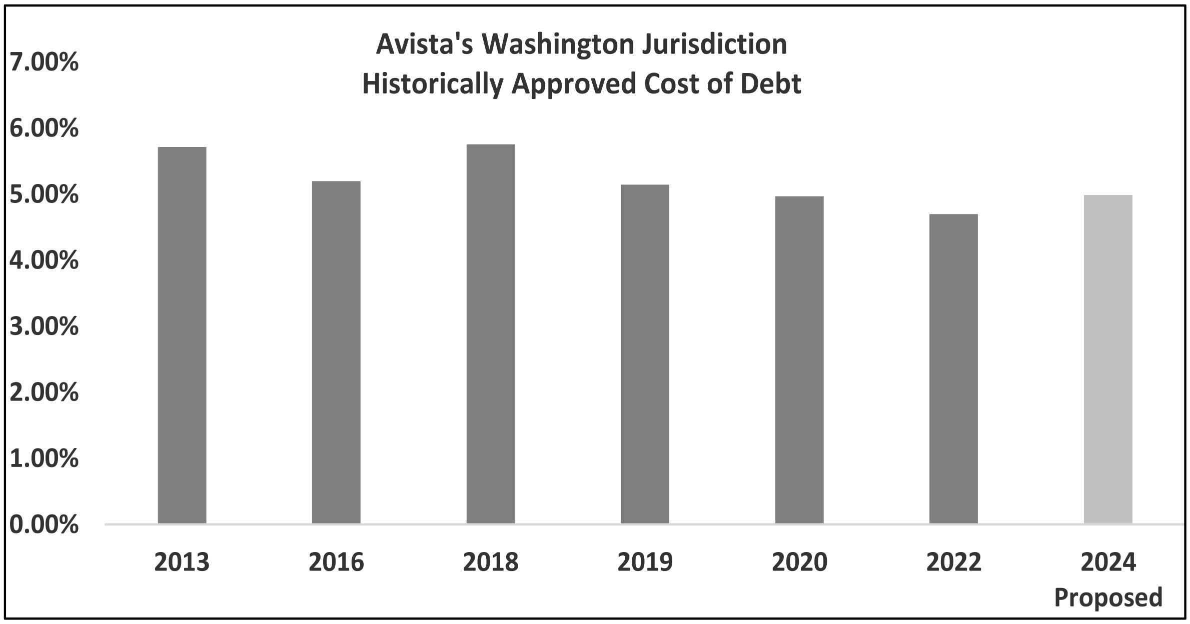
A. We are requesting a cost of capital and capital structure that provides us the opportunity to have financial metrics that offer a risk/reward proposition that is competitive and attractive for equity holders. We have steadily increased our dividend for common shareholders over the past several years, which is an essential element in providing a competitive risk/reward opportunity for equity investors. While these are important steps, over the last year utility stocks, including Avista's have continued to be challenged by rising interest rates, inflationary pressures, and wildfire risk. As discussed in McKenzie's direct testimony, the beta values which indicate an investors perception of risk, have remained elevated since 2020.[7]

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 4.99%. The authorized cost of debt has been relatively flat but has trended upward as shown in Illustration No. 2 below.

[7] Exh AMM-1T, p. 32, ll. 1-8.

<u>Illustration No. 2 – Historic Cost of Debt (Washington)</u>



Q. Explain why the cost of debt is higher in 2024?

A. From 2018 through 2023, the Company issued $1.5 billion in long-term debt. The weighted average interest rate of these issuances is 4.09%. These issuances all have 30 year maturities. Our most recent debt issuance was funded on March 29, 2023. The Company issued $250 million of first mortgage bonds and the issuance was completed at a coupon rate of 5.66%. This reflects the rise in interest rates over the last 18 months. In addition, our cost of short-term borrowings which are variable have increased substantially since our last case. Confidential Exh. KJC-3C shows the Company's planned long-term debt issuances by year for 2024-2027.

Q. How much have interest rates increased since our last rate case?

A. The Federal Reserve aggressively raised interest rates 7 times in 2022, and 4 times in 2023. The Federal Funds Rate and our short-term borrowing rate has increased about

525 basis points since the beginning of 2022. We expect rates to remain far above historical averages throughout 2024 and 2025. Higher interest rates increase the cost of borrowing under the Company's $500 million revolving credit facility and is expected to increase the cost of issuing long-term debt over the next couple of years.

Q. What is the status of the Company's credit facility?

A. The Company has a credit facility in the amount of $500 million with a maturity date of June 8, 2028.[8] The credit facility involves participation of seven banks. 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.

In June 2023, the then-existing agreement was amended to increase the capacity of the committed line of credit from $400 million to $500 million, extend the expiration date and replace the London Interbank Offered Rate (LIBOR) provisions with Secured Overnight Financing Rate[9] (SOFR) provisions. Since our last case, we have seen unprecedented volatility in natural gas and power prices which led to increased liquidity needs for purchases of physical commodities as well as significant margin calls associated with future commodity activity and hedging arrangements.

[8] The credit facility was originally established in 2011, amended in April 2014, extended in May 2016, amended and extended in June 2020, June 2021 and most recently in June of 2023.
[9] SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

V. 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 2019 through 2023, our capital expenditures ranged between $425 million and $475 million per year, on a system basis (i.e., Washington, Idaho, and Oregon, electricity, and natural gas).

Avista's plans continue to call for making significant utility capital investments in our electric and natural gas systems to preserve and enhance service reliability for our customers, including the continued replacement of aging infrastructure. Capital expenditures of approximately $500-$575 million per year, on a system basis, are planned for the three-year period ending December 31, 2026. 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. Confidential Exh. KJC-3C shows the Company's planned capital expenditures and long-term debt issuances by year for 2024-2027.

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

A. Avista's 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[10] will be funded in a given year at the level requested. Avista believes that holding capital spending below the level requested also accomplishes several important items, including:

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

- ***Balances Cost and Risk*** – Captures the 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 $500 - $575 million (system), in an effort to accomplish the objectives described above.

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 requirements 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

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[10] "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, but which may ramp up or down over time, such as the wood pole management program. For ease of reference, the term "capital project" will be used to represent both capital projects and capital programs.

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.

Several steps are involved in determining which projects should be considered for funding and how to maximize the value of limited budget dollars. Capital projects are organized into "Investment Drivers," six categories that are used to help explain the needs the project is trying to address. The Company developed these drivers in an effort to improve the transparency and consistency of decision making and they are a consideration for every project, regardless of where it resides. These drivers are:

1) **Customer Requested**. These projects are triggered by customer requests for new service connections, line extensions, transmission interconnections, transmission capacity, or system reinforcements to serve customers. Responding to customer requests for service is a requirement of providing utility service. Projects in this category also include customer service enhancements, line extensions or interconnections to serve large industrial or commercial customers, integrating customer generating projects, or requested interconnections with neighboring utilities.

2) **Mandatory and Compliance**. The investments in this category are driven typically by compliance with laws, rules, and contract requirements that are external to the Company, areas for which the Company has little or no discretion in spending. Avista operates in a complex regulatory and business framework and must adhere to national and state laws, state and federal agency rules and regulations, and county and municipal ordinances. Compliance with these rules, as well as contracts and settlement agreements, represent obligations that are generally external to the company and generally beyond Company control. Projects in this category may include the obligation to relocate facilities based on road construction projects, dam safety upgrades, air and water quality permits, NERC requirements related to the interconnected grid, FERC required transmission upgrades, etc.

3) **Failed Plant and Operations**. Although Avista responds to thousands of forced outage events every year, asset replacement due to equipment failure or an outage event is only one component of the investment required to operate natural gas and electric operations. Operating conditions are driven by seasonal variations in weather, changes in customer demand patterns, economic trends, as well as large scale events such as windstorms, floods, fire, lightning, and snowstorms. The replacement and capital repair of equipment failures constitute requirements to replace assets that have failed, and which must be replaced in order to provide continuity and adequacy of service to

customers (e.g. capital repair of storm-damaged facilities). This also includes investments in natural gas and electric infrastructure that is performed by Avista's operations staff, and which is typically budgeted under capital accounts by major asset or business class (e.g. Electric Distribution).

4) **Asset Condition**. Assets of every type will degrade with age, usage, and other factors, and must be replaced or substantially rebuilt at some point in order to ensure the reliable and acceptable continuation of service. Projects or programs in this category of need are defined as investments to replace assets based on established asset management principles and systematic programs adopted by the Company, which are designed to optimize the overall lifecycle value of the investment for our customers. The replacement of assets based on condition is essentially the practice of removing them from service and replacing them in the most cost efficiency way. This funding category replaces assets or portions of assets as needed to maintain function and usefulness, such as repairing or replacing parts that wear out, when safety or environmental concerns are identified, or when assets no longer provide optimized performance or customer value.

5) **Customer Service Quality and Reliability**. Customer Service Quality and Reliability investments are those investments required to maintain or improve the quality of services provided to customers, to introduce new types of services and options based on an analysis of customer needs and expectations, to ensure customer service quality requirements are achieved, and to meet electric system reliability objectives. These investments include such programs as the Company's Customer at the Center projects supported by Company witness Ms. Hydzik, smart meter installation, replacing aging gas pipeline, changing out underground cables to reduce outages, or installing automation devices to help isolate outages and reduce their impact.

6) **Performance and Capacity**. Avista's projects and programs responsive to this category of need include a range of investments that address the capability of assets to meet defined performance standards, typically developed by the Company, or to maintain or enhance the performance level of assets based on a demonstrated need or analysis. This driver helps ensure that assets satisfy business needs and meet performance and reliability standards. Examples might include adding a redundant feeder to reduce the chance of outages, upgrading systems to improve accuracy, monitoring, or service levels, or increasing capacity due to customer growth or to mitigate potential overloaded equipment.

Q. How are projects developed within the Company?

A. Projects are developed through various means including engineering planning studies, engineering & asset management analyses, required or scheduled upgrades, the result of observations of expert utility personnel, or as the need for investments are identified or otherwise required to provide safe and reliable service. Simply because a need is identified, though, does not mean that a project will ultimately be approved, funded, or completed. Any project will undergo internal review by multiple stakeholders within the business units themselves. There are any number of projects that are developed or scoped at some level, reviewed, and set aside for any number of reasons, including that a project might not meet the need, capital prioritization, risk mitigation, other alternatives, or resource constraints, among other things, within business units. For those projects that make it through that "informal phase gate", they will then go through a more formal review process at the appropriate business area level. Some of the more formal functional review teams are:

Engineering Round Table (ERT) evaluates and recommends business cases for electric Transmission, Substation, or Protection projects and prioritizes resources for those projects. It is comprised of a diverse group of engineering leaders[11] who track project requests, prioritize them, and establish committed construction package dates and required in-service dates for projects.

Generation, Production and Substation (SCRUM) is responsible for all projects within the scope of electric Generation, Production, and Substation Support. Each year Avista makes investment decisions for its generating facilities with the goals of maximizing the value of limited funding and other resources while managing competing requirements and aligning with Company goals and objectives. The group utilizes a process known as the Scheduling, Cost, and Resource Utilization Meeting or "SCRUM" to develop capital project requests. In these meetings, generation leaders and stakeholders discuss criticality, risks, costs, mandatory requirements, resource requirements, alternatives, and options in order to select and prioritize projects.

Operations Round Table (ORT) manages requests related to electric Distribution programs including new customer service, wood pole and vegetation management,

[11] Eleven representatives are included in this group from: Transmission and Distribution Planning, Transmission, Distribution, and Substation Design, System Protection, System Operations, Asset Management, Communications and Generation Engineering, and Transmission Services.

storm restoration, transformer change outs, streetlights, and grid modernization. This also includes the meter shop.

Technology Planning Group (TPG) oversees technology projects and selects and prioritizes those that will be sent on for potential funding. The TPG in conjunction with the Enterprise Technology Steering Committee (ETSC) oversee Avista's investments in technology. They act as the custodian and governance body of Avista's technology investments across the enterprise by focusing on strategic long-term investment planning and oversight of resource or funding constraints across the technology investments.

Gas Engineering Prioritization Investment Committee (EPIC) is accountable for the capital projects and programs that fall under the scope of natural gas operations and construction. Annually, this group prioritizes the projects and assess the spending level of the programs to support safe and reliable operation of the natural gas system and to maintain compliance with both State and Federal Regulations. The intent is to maximize risk reduction acknowledging there are limited funds to accomplish this. This committee reviews spend and budget data to provide monthly updates to the Capital Planning Group, as needed. The Business Cases to support these efforts are managed by this committee, reviewed by the Manager of Gas Engineering, and approved by the Director of Natural Gas.

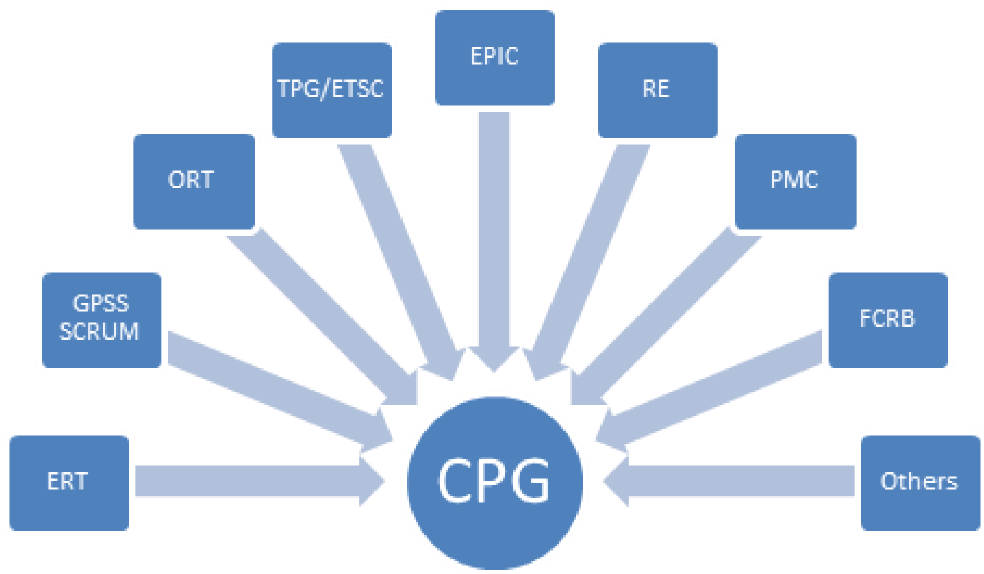
Real Estate and Environmental (RE) develops budgets for business cases based on requirements of our Clark Fork River and Spokane River FERC hydro licenses, as well as local, state & federal regulations related to environmental, hydro safety and rights-of-way matters. The final proposed budgets are informed by analysis of these requirements as well as resource availability to carry out capital projects and past patterns of project costs.

The Property Management Committee (PMC) ensures that the planning, purchasing, selling, and managing of real property is aligned with overall company strategies. The Committee will identify specific actions to improve that alignment, assess current policies and approaches related to property management and identify and adopt needed changes or new policies. The Committee ensures that decision-making processes related to real property are clear and effective and develop cohesive long-term strategies for managing properties.

Facilities Capital Request Board and Large Facilities Project Steering Committee (FCRB) vet facilities-related requests from across the service territory. If projects are approved by this Board, they are prioritized based on risk, safety, environmental impact, and compliance then sent on to the Capital Planning Group.

Illustration No. 3 provides a simple schematic of how these groups ultimately provide input to the Capital Planning Group, or CPG, who decides the funding for proposed projects, as described later in my testimony:

<u>Illustration No. 3 – Project Team Schematic</u>



Q. What are the requirements from a business plan perspective as it relates to documenting the need for a project?

A. In recent years Avista developed a Business Case template that is required for any capital project that is approved by the committees referenced earlier (and prior to funding). 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 options considered, the selected alternative and the timeline associated with the project. Avista is committed to making optimal investment decisions on behalf of our customers and stakeholders. Thorough, accurate, and evidence-based business case analyses are foundational to the capital investment decision making process. There have been ongoing improvement efforts over several years to improve and standardize the business case process, focusing on customers, financial and performance metrics, financial and risk analysis, prudence, and documentation. We have also integrated in our templates feedback received from parties and the Commission from prior general rate cases, so that those interested parties can also better understand the development and deployment of our capital projects. These improvement efforts have resulted in more robust narratives, increased standardization of processes and templates, and additional training.

When Avista makes any capital investment there is an obligation to demonstrate that the overall need, evaluations of alternatives, and the planned timing of implementation is prudent, and in the customer's best interests. Whether the investment touches the customer directly, such as customer service or metering systems, or indirectly, such as improving the capability and efficiency of employees and internal work processes, each dollar invested ultimately supports one purpose: to provide customers with safe, reliable, and cost-effective energy services that meet their expectations for quality of service and value.

The business case community of owners, sponsors, project managers and key contributors need support to help ensure thorough, consistent, accurate, and timely business cases. As such, the Company has utilized a Business Case Review Team (BCRT). The BCRT's purpose is to continuously improve and oversee our business cases by ensuring the required justification, options, analyses, metrics, and documentation is described and provided. It is meant to be a "center of excellence" to refine and maintain the business case framework and to provide support for the business case community. The BCRT also supports improving processes and templates and providing training and business case peer reviews to help business case owners understand and include all the essential elements of a complete business case. Ultimately, these efforts will enable Avista to meet its goal of having complete information at the right time for prioritization and capital decision making and contributing towards ensuring prudency standards are met.

Q. Once all of the projects are approved in their various committees, what is the next step in the approval process?

A. The various business units perform a thorough vetting of projects in their specific areas of responsibility. The resulting supported business cases are then sent to the CPG for final review and consideration. The CPG is comprised of Avista directors from across all of the capital-intensive areas of the Company as well as others from the Finance and Regulatory groups. The CPG has the responsibility of determining how the capital budget, at a level which is approved by the Finance Committee of the Board of Directors, will be allocated across the business. The CPG evaluates all of the projects proposed for funding from a Company-wide perspective. Based on the members expertise and considerable discussion and give-and-take, the CPG ultimately determines which projects should be funded in full, in part, or which should be deferred to future years in order to stay within budget, all while appropriately balancing the risks of the Company while providing safe and reliable service to our customers.

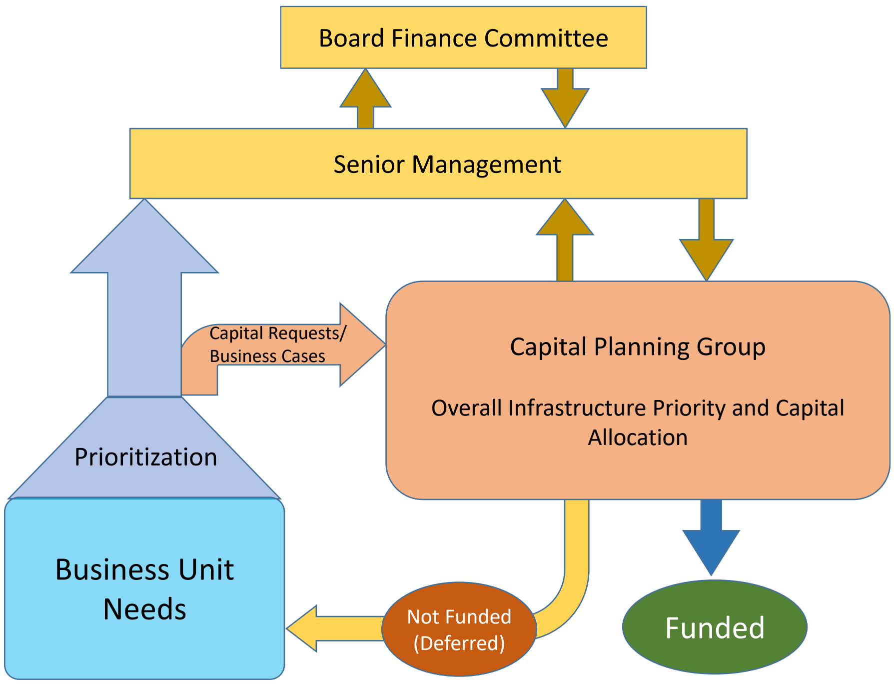
Q. What does the CPG take into account in their determination of funding?

A. The CPG considers the immediacy of the need for investment, the financial and other impacts/risks of deferring projects, as well as safety, reliability, and partial funding versus an “all or nothing” approach. This group also evaluates and discusses the consequences of not funding projects. Based on this iterative and comparative assessment, the team adjusts the list of projects to be funded, as well as the amounts to be funded, to arrive at the best-balanced allocation of capital among priority needs across the business. The final allocation recommended by the CPG reflects the need to fund the highest priority investments first, on a Company-wide basis, while taking care to ensure that the investments deferred will not result in excessive cost or risk.

Q. After the CPG balances the requests of the Company within the financial constraints, what happens next?

A. Once funding is allocated to priority projects for the coming three-year period, the CPG presents the budget to Avista's senior management who provide feedback and future direction, and ultimately approve the three-year funding plan. Planned spend by business driver is presented to the Finance Committee of the Board of Directors for the following year, which after discussion and the opportunity for amendment, approves the funding plan. The status of the planned versus actual investment spending is reviewed with the Finance Committee at least twice each year. In the end, the approved capital funding plan demonstrates a reasonable balance among competing needs required to maintain the performance of Avista's systems, as well as prudent management of the overall enterprise in the best interest of customers. The process under which Avista's planned capital expenditures are identified and prioritized is illustrated in Illustration No. 4 below.

<u>Illustration No. 4 – Identification and Prioritization Process</u>



As discussed earlier, 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 are developed for each of the Capital Requests that go to the CPG. The CPG prioritizes the Capital Requests across departments, 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), as shown on the diagram. Each year, the Board Finance Committee reviews and approves the first year of the rolling three-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.

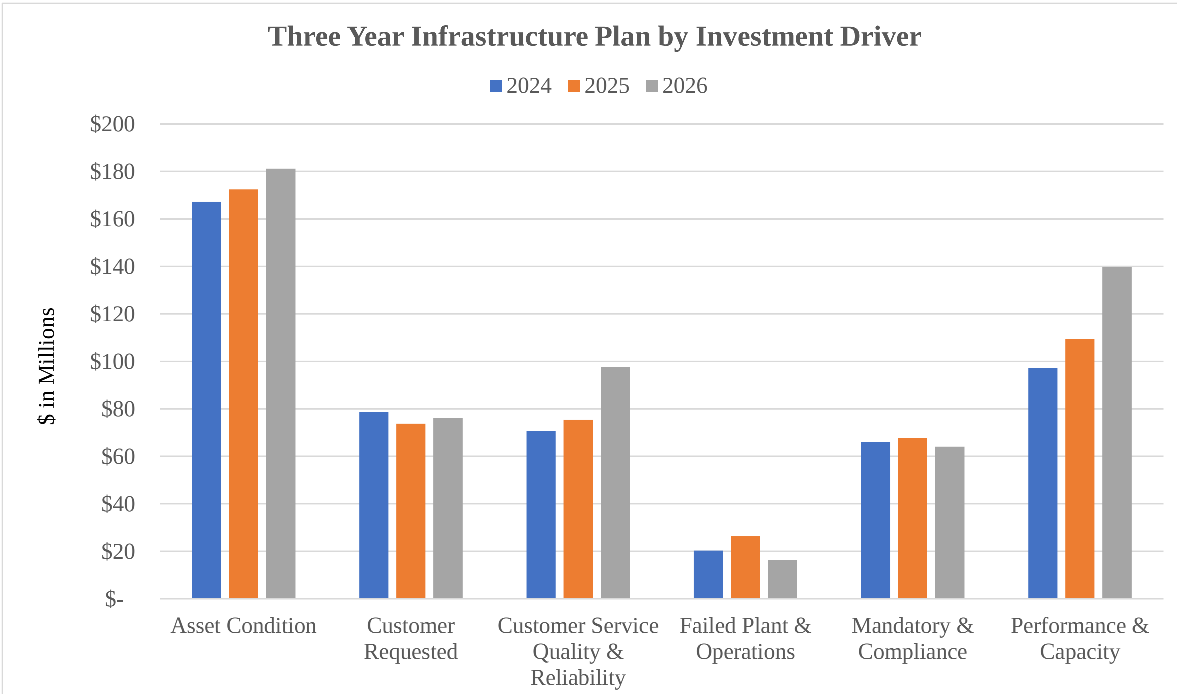
Q. Once the projects are approved, and the summarized plan is approved by the Finance Committee of the Board, is the plan essentially fixed and static?

A. Not at all. All good plans necessarily change. The projects in the Company's portfolio are regularly reviewed for changes in assumptions, constraints, project delays, accelerations, weather impacts, outage coordination, system operations, performance, permitting/licensing/agency approvals, safety, and customer-driven needs that arise. In recent years, we can also add pandemics to that list as well. The portfolio is continually updated throughout the year to remain as appropriate as possible.

Q. Would you please provide a summary of the Company's planned investments, by Investment Driver?

A. Yes. A breakdown of planned investments for each driver for 2024-2026 is shown in Illustration No. 5 below.

<u>Illustration No. 5 – Planned Investments by Capital Investment Driver (2024-2026)</u>



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. 3 below. The dollar amounts for projects that were delayed (not approved) are also shown:

<u>Table No. 3: Capital Project Requests/Approvals ($ in millions)</u>

Year	Requested	Approved	Delayed	% Capital Delayed
2019	$528	$405	$123	**23%**
2020	$505	$405	$100	**20%**
2021	$516	$407	$109	**21%**
2022	$501	$475	$26	**5%**
2023	$523	$475	$48	**9%**
2024	$598	$500	$98	**16%**
2025	$689	$525	$164	**24%**
2026	$648	$575	$73	**11%**

As demonstrated in Table No. 3 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 approved capital budget level. Put another way, Avista could fully justify increasing its capital budget to <u>well over</u> $600 million over the next several years, but is choosing not to, in order to balance investment need with customer affordability.

Q. Table No. 3, above, shows a much higher proportion of capital projects delayed. What accounts for that?

A. In short, the Company has necessarily smoothed our capital investments, balancing the overall rate pressure caused by capital investments on our customers, with a level that still allows Avista to provide safe and reliable service, while also balancing the risks of the organization along with the workloads of our crews and available contractors.

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

A. That information is covered in general by Company witness Ms. Schultz, with the restating and pro forma capital adjustments provided by Company witness Ms. Benjamin. Other Company witnesses, (i.e., Mr. Alexander regarding Production assets; Mr. DiLuciano regarding Transmission, Electric and Natural Gas Distribution, and General Assets; Mr.

Manuel regarding the costs associated with Avista's Information Service/Information Technology (IS/IT) projects; Mr. Howell regarding Wildfire investment, and Ms. Hydzik regarding investment related to Customer Technology and Electric Vehicle programs) provide more specific information on the capital projects included in this case. These investments reflect, among other things, replacement, and maintenance of Avista's utility system and the need to sustain reliability, safety, and service to customers.

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

A. Yes.