Exh. MTT-1T

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EXHIBIT: MTT-1T
ADMIT ☑ W/D ☐ REJECT ☐

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-19________

DOCKET NO. UG-19________

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

2 **Q. Please state your name, business address, and present position with Avista**
3 **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
11 management, 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
14 Hills Corporation, a diversified energy company, providing regulated electric and natural gas
15 service to areas of South Dakota, Wyoming and Montana. I joined Black Hills Corporation
16 in 1997 upon leaving InterCoast Energy Company in Des Moines, Iowa, where I was the
17 manager of accounting. Previous to that I was a senior auditor for Arthur Andersen & Co. in
18 Chicago, Illinois.

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

20 A. I will provide a financial overview of Avista Corporation as well as explain
21 our credit ratings and the Company's proposed capital structure and overall rate of return in
22 this case. Company witness Mr. McKenzie will provide additional testimony related to the
23 appropriate return on equity for Avista, based on our specific circumstances, together with the

1 current state of the financial markets. I will provide an overview of our capital expenditures
2 program, and other witnesses will provide details on what capital expenditures we are making,
3 and why they are necessary in the time frame in which they are planned.

4 In brief, I will provide information that shows:

5–11
1. Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB and Baa2 from Moody's Investors Service. Avista must operate at a level that will support a solid investment grade corporate credit rating in order to access capital markets at reasonable rates. A supportive regulatory environment is an important consideration by the rating agencies when reviewing Avista. Maintaining solid credit metrics and credit ratings will also help support a stock price necessary to issue equity under reasonable terms to fund capital requirements.

12–17
2. We are proposing an overall rate of return of 7.52 percent, which includes a 50 percent common equity ratio, a 9.9 percent return on equity, and a cost of debt of 5.15 percent. We believe our proposed overall rate of return of 7.52 percent and the proposed capital structure provide a reasonable balance between safety and economy.

18–26
3. Avista's plans call for a continuation of utility capital investments in generation, transmission and distribution systems and technology to preserve and enhance service reliability for our customers. Capital expenditures of $405 million per year (system) are planned for the five-year period ending December 31, 2023. 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.

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

Line		Description	Page
28		Description	Page
29	I.	Introduction	1
30	II.	Financial Overview	3
31	III.	Capital Expenditures	4
32	IV.	Maturing Debt	13
33	V.	Proposed Capital Structure and Cost of Capital	15
34	VI.	Credit Ratings	30

1 **Q. Are you sponsoring any exhibits with your direct testimony?**
2 A. Yes. I am sponsoring Exh. MTT-2 pages 1 through 7, which were prepared
3 under my direction. Avista's credit ratings by S&P and Moody's are summarized on page 1.
4 Avista's proposed capital structure and cost of capital are included on page 2, with supporting
5 information on pages 3 through 7. Confidential Exh. MTT-3C is our Interest Rate Risk
6 Management Plan. Exh. MTT-4 is the Company's March 2019 Infrastructure Investment
7 Plan. Confidential Exh. MTT-5C shows the Company's planned capital expenditures and
8 long-term debt issuances by year for 2019-2023.
9
10 **II. FINANCIAL OVERVIEW**
11 **Q. Please provide an overview of Avista's financial situation.**
12 A. Avista has and will continue to operate the business efficiently to keep costs as
13 low as practicable for our customers, while at the same time ensuring that our energy service
14 is reliable and our customers are satisfied. An efficient, well-run business is not only
15 important to our customers but also important to investors. Our capital financing plan, and
16 our execution of that plan, provides a prudent capital structure and liquidity necessary for
17 utility operations. We initiate regulatory processes to recover our costs in a timely manner
18 with the goal of achieving earned returns close to those allowed by regulators in each of the
19 states we serve. These elements – cost management, ready access to capital and revenues that
20 support operations – are key determinants to the rating agencies when they are reviewing our
21 overall credit ratings.
22 **Q. What steps is the Company taking to maintain and improve its financial**
23 **health?**

1 A. We are working to assure there are adequate funds for operations, capital
2 expenditures and debt maturities. We obtain a portion of these funds through the issuance of
3 long-term debt and common equity. We actively manage risks related to the issuance of long-
4 term debt through our interest rate risk mitigation plan and we maintain a proper balance of
5 debt and common equity through regular issuances and other transactions. We actively
6 manage energy resource risks and other financial uncertainties inherent in supplying reliable
7 energy services to our customers. We create financial plans and forecasts to model our
8 income, expenses and investments, providing a basis for prudent financial planning. We seek
9 timely recovery of our costs through general rate cases and other ratemaking mechanisms.
10 The Company currently has a sound financial profile and it is very important for Avista
11 to maintain and enhance its financial position in order to access debt and equity financing
12 under reasonable terms as Avista funds significant future capital investments and refinances
13 maturing debt.
14
15 **III. CAPITAL EXPENDITURES**
16 **Q. What is the Company's recent history related to capital investments?**
17 A. We are making significant capital investments in our electric generation,
18 transmission and distribution facilities, natural gas distribution system, and new technology to
19 better serve the needs of our customers. These investments are focused on, among other things,
20 the preservation and enhancement of safety, service reliability and the replacement of aging
21 infrastructure. For the period 2014 through 2018, our capital expenditures were approximately
22 $400 million per year, on a system basis. While there are variations among the functional areas
23 targeted for investment each year, the predominant areas have included natural gas distribution

1 plant, electric generation, transmission and distribution facilities, new customer hookups,
2 environmental and regulatory requirements, information technology and other supporting
3 functions, such as fleet services and facilities.

4 **Q. What are Avista's recent and planned capital expenditure levels?**

5 A. Illustration No. 1 below summarizes the capital expenditure levels for recent
6 years, as well as planned expenditures through 2023.

7 **Illustration No. 1 – Capital Expenditures**

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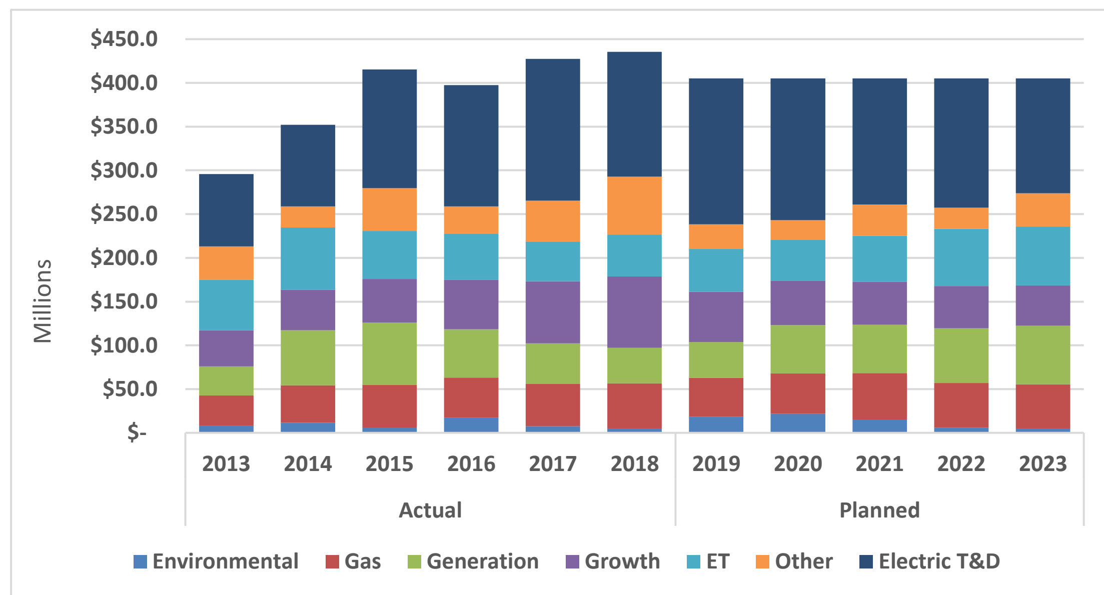

17 The capital expenditure level is expected to remain constant at $405 million (system)
18 annually from 2019 through 2023.

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

21 A. I will summarize why Avista is making capital investments in the time frame
22 they are being completed, and the process we use for identifying and prioritizing those
23 investments. Company witnesses Mr. Thackston, Ms. Rosentrater, and Mr. Kensok provide

1 details of our completed capital projects, as well as major projects included in Company
2 witness Ms. Schuh's pro forma capital adjustment. Those witnesses address why they need
3 to be done in the planned time frame, and what the risks and consequences are of not
4 completing the projects in that time frame.

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

13 14 15 16
- ***Promotes Innovation*** – Encourages ways to satisfy the identified investment needs in a manner that may identify potential cost savings, defer implementation, or other creative options or solutions.

17 18 19 20
- ***Balances Cost and Risk*** – Captures the customer benefits of deferring needed investments by prudently managing the cost consequences and risks associated with such deferrals.

21 22 23
- ***Efficiently Allocates Capital*** – Ensures that the highest-priority needs are adequately funded in the most efficient and effective way.

24 25 26 27
- ***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.

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

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

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

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

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

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

1. Respond to customer requests for new service or service enhancements;
2. Meet our customers' expectations for quality and reliability of service;
3. Meet regulatory and other mandatory obligations;
4. Address system performance and capacity issues;

1 5. Replace infrastructure at the end of its useful life based on asset condition; and

2 6. Replace equipment that is damaged or fails, and support field operations.

3 An explanation of each of these drivers, as well as examples of specific capital projects
4 under these drivers, is provided in the Infrastructure Investment Plan, attached as Exh. MTT-
5 4. In addition, Company witnesses Mr. Thackston, Ms. Rosentrater, and Mr. Kensok provide
6 details on the specific capital projects planned and in progress, why the projects need to be
7 done in the time frame they will be completed, as well as what the risks and consequences are
8 of not completing the projects.

9 A breakdown of planned investments for each driver for 2019-2023 is shown in
10 Illustration No. 2 below.

11 **Illustration No. 2 – Planned Investments by Capital Investment Driver (2019 – 2023)**

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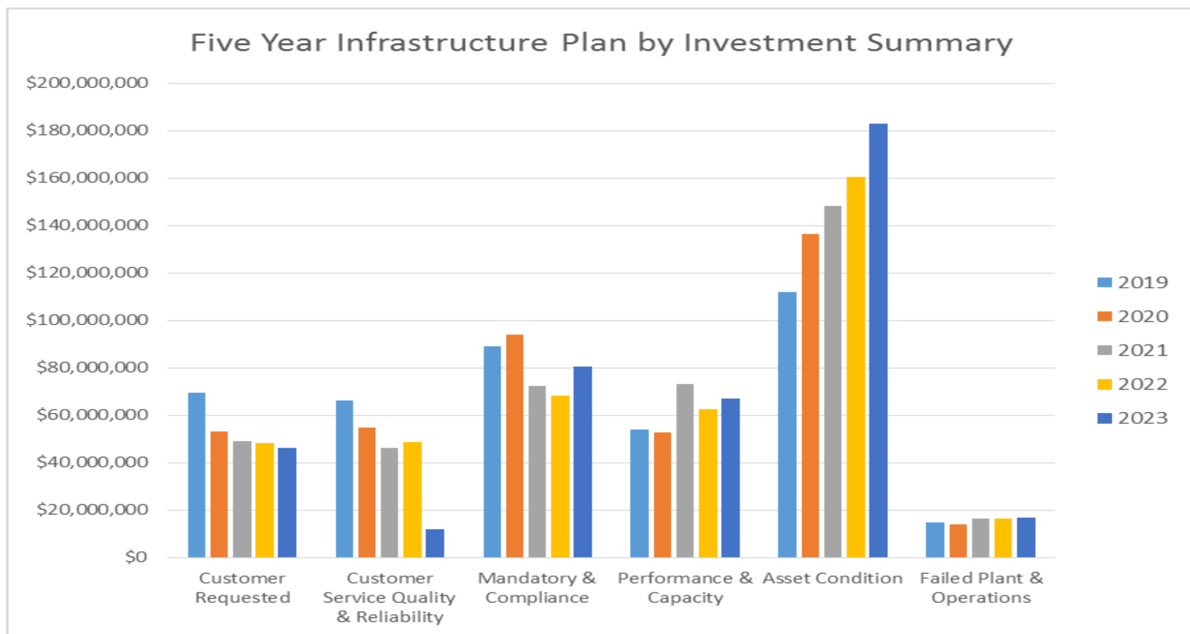

20 The process under which Avista's planned capital expenditures are identified and
21 prioritized is illustrated in Illustration No. 3 below.

1 **Illustration No. 3 - Identification and Prioritization Process**

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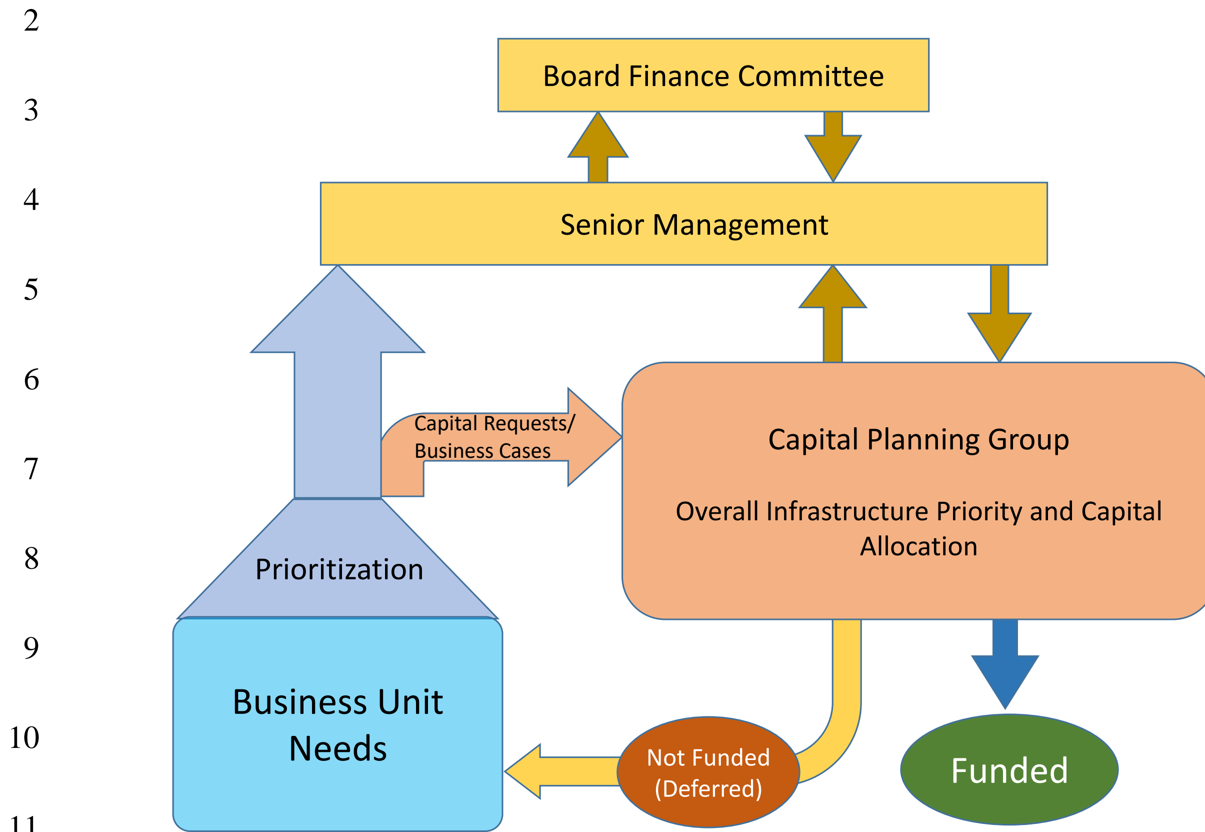

12 The capital projects are identified in the lower-left portion of the diagram labeled
13 "Business Unit Needs," and are then prioritized within each department. This prioritization
14 occurs with the knowledge of the continuing constraint on the capital spend level for the
15 Company, while at the same time the leadership of each department informs Senior
16 Management of both the near-term and longer-term needs that are being delayed. For the
17 prioritized projects, Business Cases[2] are developed for each of the Capital Requests that go to
18 the Capital Planning Group (CPG) (as illustrated in the diagram). The CPG prioritizes the

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

1 Capital Requests across departments, such that the overall planned capital spend stays within
2 the constrained spend level established by Senior Management. The highest priority Capital
3 Requests are "Funded", and a portion of the Capital Requests are "Not Funded" (Deferred),
4 as shown on the diagram. Each year, the Board Finance Committee reviews and approves the
5 first year of the rolling five-year capital investment plan. Under this Identification and
6 Prioritization Process, the capital projects are screened and prioritized twice; once within the
7 departments, and then a second time across departments within the CPG. This Identification
8 and Prioritization Process is explained in more detail in the Infrastructure Investment Plan in
9 Exh. MTT-4.

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

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

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

20 A. The primary drivers that have affected Avista's level of capital investment
21 includes the business need to fund a greater portion of the departmental requests for new
22 capital investment that, in the past, have not been funded, and the need to capture investment
23 opportunities and benefits identified by our asset management programs.

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

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

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

Year	Requested	Approved	Delayed	% Capital Delayed
2017	$461	$405	$56	12%
2018	$455	$405	$50	11%
2019	$528	$405	$123	23%
2020	$516	$405	$111	22%
2021	$501	$405	$96	19%
2022	$467	$405	$62	13%

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

1 **Q. What is driving the investment in utility plant in Washington?**
2 A. As discussed in more detail by Company witness Ms. Andrews, the increase
3 in overall costs to serve customers is driven primarily by the continuing need to replace and
4 upgrade the facilities and technology we use every day to serve our customers, while revenue
5 growth remains low. In particular, Rate Year 1 of the Company's requested rate relief is
6 higher primarily because Rate Year 1 is in a sense, trying to "catch up" its recovery of capital
7 investment in-service, serving customers through calendar-year 2018, compared to that
8 currently included in rates. This "catch up" of capital investment through 2018 alone equates
9 to approximately $238.9 million for electric and $100.8 million for natural gas in increased
10 gross plant investment. Additionally, the Company has pro formed gross plant additions for
11 2019 (20 discreet "major" projects) into the Company's electric and natural gas cases, totaling
12 $84.9 million and $26.5 million, respectively.
13 Ms. Schuh sponsors the restating and pro forma capital adjustments which incorporate
14 the effects of these capital investments in the determination of the Company's proposed
15 revenue requirements. Other Company witnesses, (i.e., Mr. Thackston regarding production
16 assets; Ms. Rosentrater regarding transmission, electric and natural gas distribution and
17 general assets; and Mr. Kensok regarding the costs associated with Avista's Information
18 Service/Information Technology (IS/IT) projects) provide more specific information on
19 certain "major" capital projects during the historical periods 2017 and 2018, as well as the
20 2019 "major" pro forma capital projects included in this case, describing the need for and
21 timing of these capital projects. These investments reflect, among other things, replacement
22 and maintenance of Avista's utility system and to sustain reliability, safety, and service to
23 customers. Major projects include the continued Aldyl-A Pipe Replacement program, Nine

1 Mile and Little Falls Redevelopment, Distribution Grid Modernization, certain transmission
2 and substation rebuilds, Customer Facing Technology Projects, Enterprise & Control
3 Network Infrastructure, Central Office Facility updates, and the overall systematic
4 replacement of aging infrastructure, among others.
5

6 **IV. MATURING DEBT**

7 **Q. How is Avista affected by maturing debt obligations from 2019 through**
8 **2023?**

9 A. Beginning in 2019 through 2023 the Company is obligated to repay maturing
10 long-term debt totaling $405.5 million as shown in Table No. 2 below. Within this forward
11 looking five-year period, a large concentration – $250 million – matures within the second
12 quarter of 2022.

13 **Table No. 2**

14–18

Avista Corp Long-Term Debt Maturities, 2019-2023				
Maturity Year	**Principal Amount**	**Coupon Rate**	**Date Issued**	**Maturity Date**
2019	$ 90,000,000	5.450%	11/18/2004	12/1/2019
2020	$ 52,000,000	3.890%	12/20/2010	12/20/2020
2021	-	-	-	-
2022	$ 250,000,000	5.125%	9/22/2009	4/1/2022
2023	$ 5,500,000	7.530%	5/6/1993	5/5/2023
	$ 1,000,000	7.540%	5/7/1993	5/5/2023
	$ 7,000,000	7.180%	8/12/1993	8/11/2023
Total	**$ 405,500,000**			

19

20 These debt obligations originated as early as 1993 and their original terms were
21 between 10 and 30 years. These maturing obligations represent 23 percent of the Company's
22 long-term debt outstanding at the end of 2018, which is a significant portion of our capital
23 structure. It will be necessary for Avista to be in a favorable financial position to complete

1 the expected debt refunding under reasonable terms, while also obtaining debt and equity to
2 fund capital expenditures each year.

3 **Q. What are the Company's expected long-term debt issuances through**
4 **2023?**

5 A. To provide adequate funding for the significant capital expenditures noted in
6 Section III above and to repay maturing long-term debt, we are forecasting the issuance of
7 long-term debt in each year through 2023. We plan to issue $165 million in 2019. Issuances
8 planned for 2020 through 2023 are provided in Confidential Exh. MTT-5C.

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

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

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

17 A. Yes. In addition to long-term debt, the Company's $400 million revolving
18 credit facility expires in April 2021. The Company relies on this credit facility to provide,
19 among other things, funding to cover daily and month-to-month variations in cash flows,
20 interim funding for capital expenditures, and credit support in the form of cash and letters of
21 credit that are required for energy resources commitments and other contractual obligations.
22 Our credit facility was amended in May 2016, which extended the expiration date to April 18,
23 2021, and reduced interest rates and fees. The Company expects to initiate the renewal or

1 replacement of the credit facility before the existing arrangement expires. Any outstanding
2 balances borrowed under the revolving credit facility become due and payable when the
3 facility expires. A strong financial position will be necessary to gain access to a new or
4 renewed revolving credit facility, under reasonable terms, prior to expiration of the existing
5 facility.
6
7 **V. PROPOSED CAPITAL STRUCTURE AND COST OF CAPITAL**

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

10 A. Our proposed capital structure is 50 percent debt and 50 percent equity, with a
11 proposed cost of debt of 5.15 percent, a proposed 9.9 percent return on equity (ROE), and a
12 requested overall rate of return (ROR) in this proceeding of 7.52 percent, as shown in Table
13 No. 3 below.[3] The proposed capital structure for the Two-Year Rate Plan is calculated
14 excluding short-term debt.

15 **Table No. 3**

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AVISTA CORPORATION
Proposed Cost of Capital

	Proposed Structure	Component Cost	Weighted Cost
Total Debt	50.0%	5.15%	2.57%
Common Equity	50.0%	9.90%	4.95%
Total	100.0%		7.52%

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

1 **Q. Why is Avista proposing to exclude short-term debt from the capital**
2 **structure calculation in this case?**
3 A. As explained by Mr. Vermillion and Ms. Andrews, the results from the electric
4 and natural gas Pro Forma Studies will not yield the rate relief necessary to provide the
5 Company the opportunity to earn the proposed ROR requested in this case. One of the rate
6 making "tools" identified by this Commission that can be used to arrive at an end result that
7 provides sufficient revenues is the use of an adjusted capital structure.[4] Both Idaho and
8 Oregon currently use this ratemaking tool of adjusting the capital structure by excluding short-
9 term debt from the calculation. Avista's currently approved capital structure in Idaho and
10 Oregon includes 50 percent equity and 50 percent debt. In this case Avista is proposing a
11 similar adjustment to its capital structure, excluding short-term debt from the calculation. The
12 calculation of the proposed capital structure is provided at page 6 of Exh. MTT-2.
13 **Q. Why is the Company planning to maintain an equity ratio at this level?**
14 A. Maintaining a 50 percent common equity ratio, excluding short-term debt, has
15 several benefits for customers. We are dependent on raising funds in capital markets
16 throughout all business cycles. These cycles include times of contraction and expansion. A
17 solid financial profile will assist us in accessing debt capital markets on reasonable terms in
18 both favorable financial markets and when there are disruptions in the financial markets.
19 Additionally, this common equity ratio solidifies our current credit ratings and moves
20 us closer to our long-term goal of moving our corporate credit rating from BBB to BBB+. A

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

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

6 **Q. Did the Commission recently reject Avista's proposed 50 percent equity**
7 **layer in its last general rate case?**

8 A. Yes, but what is different than before is that Avista was downgraded by
9 Moody's Investors Service in December 2018. As I stated before, granting a higher equity
10 layer in this case could assist us in moving further away from non-investment grade. Further,
11 the Commission does not employ bright lines, even in this case. While the Commission stated
12 in Order 07 in our last general rate case that use of a hypothetical capital structure should be
13 reserved for financial hardship or access to capital market conditions, use of such a capital
14 structure is "not limited to" such conditions.

15 **Q. Would acceptance of a hypothetical capital structure perhaps send a**
16 **positive signal to rating agencies, and put Avista perhaps on a path towards an upgrade?**

17 A. I believe so. One of the conditions that led to the recent Moody's downgrade
18 was that the "Baa2 rating also looks at Avista's less predictable regulatory outcomes in
19 Washington, where the Company generates about 60% of its revenue. Although the state has
20 some credit supportive mechanisms, such as revenue decoupling, the use of historic test years
21 results in the need file general rate cases more frequently."[5] They later state that a "rating

[5] Moody's Investors Service, "Moody's Downgrades Avista Corp. to Baa2, Outlook Stable", December 20, 2018, p. 1

1 upgrade could be considered with a demonstrated improvement in regulatory relationships."[6]
2 In our view, approval of a hypothetical capital structure, approval of the continuation of the
3 Decoupling Mechanisms (as discussed by Company witness Mr. Ehrbar), and inclusion of
4 more capital additions in rates would be helpful.

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

7 A. A key component of a continued long-term sound financial profile is the ability
8 to receive timely recovery of capital additions and expenses, so the Company can earn its
9 authorized return. When regulatory mechanisms do not respond to changing cost factors, the
10 level of return can move substantially below the authorized level. This creates financial
11 weakness and concern in financial markets about the long-term stability of the Company.

12 Both Moody's and S&P cite the regulatory environment in which a regulated utility
13 operates as the dominant qualitative factor to determine a company's creditworthiness.
14 Moody's rating methodology is based on four primary factors. Two of those factors – a
15 utility's "regulatory framework" and its "ability to recover costs and earn returns" – make up
16 50 percent of Moody's rating methodology[7].

17 S&P states the following[8]:

18 Regulation is the most critical aspect that underlies regulated integrated
19 utilities' creditworthiness. Regulatory decisions can profoundly affect
20 financial performance. Our assessment of the regulatory environments in
21 which a utility operates is guided by certain principles, most prominently
22 consistency and predictability, as well as efficiency and timeliness. For a
23 regulatory process to be considered supportive of credit quality, it must limit
24 uncertainty in the recovery of a utility's investment. They must also eliminate,

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[6] Moody's Investors Service, "Moody's Downgrades Avista Corp. to Baa2, Outlook Stable", Dec. 20, 2018, p. 2
[7] Moody's Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, June 23, 2017.
[8] Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.

or at least greatly reduce, the issue of rate-case lag, especially when a utility engages in a sizable capital expenditure program.

Because of the major capital expenditures planned by Avista and future maturities of long-term debt, a supportive regulatory environment is essential in maintaining our current credit rating. Language from Moody's Credit Opinion on Avista Corporation issued on December 21, 2018, emphasizes the need for timely recovery of costs in Washington:[9]

> …the company has had a contentious regulatory relationship with the commission in recent history. Avista's February 2016 rate filing was rejected by the WUTC in December 2016, and the company's request for reconsideration of the decision was rejected by the commission in February 2017. This was a surprising outcome considering our view that a core competency of utility management is managing regulatory relationships, making an outright denial by the regulator unusual and unexpected. Since the WUTC is Avista's most important regulator, overseeing roughly 60% of the company's rate base and revenue generation, a strong regulatory relationship with the WUTC is important for adequate regulatory relief and for Avista's credit.

Q. Is recent federal tax reform another reason by the Commission should approve the Company's proposed hypothetical capital structure?

A. Yes. As Mr. McKenzie testifies to on behalf of the Company, Amendments to the tax code stemming from the Tax Cuts and Jobs Act ("TCJA") have served to reduce rates for customers, but they also have had detrimental implications for the credit standing of regulated utilities. By lowering the income tax allowance reflected in rates and requiring the eventual refund of excess accumulated deferred income taxes, the TCJA results in reduced cash flow and weaker credit metrics for utilities.

[9] Moody's Investors Service, Credit Opinion, "Avista Corp.: Update following downgrade to Baa2, outlook stable", December 21, 2018.

1 For example, Moody's initially revised its ratings outlook for 24 utilities from "stable"
2 to "negative," and one utility from "positive" to "stable," due to the potential impact of the
3 TCJA on cash flows and financial integrity.[10] As Moody's observed:

4 Investors-owned utilities' rates, revenue and profits are heavily regulated. The
5 rate regulators allow utilities to charge customers based on a cost-plus model,
6 with tax expense being one of the pass-through items. In practice, regulated
7 utilities collect revenues from customers based on book tax expense but
8 typically pay much less tax in cash. Under the new tax regime, utilities will
9 collect less revenue associated with tax expenses and pay out more cash tax,
10 squeezing its cash flows.[11]

11 Moody's noted that supportive regulatory actions, in the form of timely cost recovery and
12 constructive determinations regarding capital structure and ROE, would be important to stave
13 off deterioration in credit metrics and potential ratings downgrades.[12]

14 Similarly, S&P highlighted the potential negative financial consequences of the TCJA
15 for rate-regulated utilities:

16 The impact of tax reform on utilities is likely to be negative to varying degrees
17 depending on a company's tax position going into 2018, how its regulators
18 react, and how the company reacts in return. It is negative for credit quality
19 because the combination of a lower tax rate and the loss of stimulus provisions
20 related to bonus depreciation or full expensing of capital spending will create
21 headwinds in operating cash-flow generation capabilities as customer rates are
22 lowered in response to the new tax code. . . . Regulators must also recognize
23 that tax reform is a strain on utility credit quality, and we expect companies to
24 request stronger capital structures and other means to offset some of the
25 negative impact.[13]

[10] Moody's Investors Service, *Moody's changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, Ratings Action (Jan. 19, 2018).
[11] Moody's Investor Service, *Tax reform is credit negative for sector, but impact varies by company,* Sector Comment (Jan. 24, 2018).
[12] Moody's Investors Service, *Moody's changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, Ratings Action (Jan. 19, 2018).
[13] S&P Global Ratings, *U.S. Tax Reform: For Utilities' Credit Quality, Challenges Abound*, RatingsDirect (Jan. 24, 2018) (emphasis added).

1 **Q. How does the Company's weighted average cost of equity compare to**
2 **others natural gas utilities in the United States?**
3 A. As shown in Illustration No. 4, Avista proposed weighted average cost of
4 equity is in-line with other utilities authorized weighted average cost of equity, and that our
5 present weighted average cost of equity is at the low end of actual, commission-authorized
6 values:
7 **Illustration No. 4**
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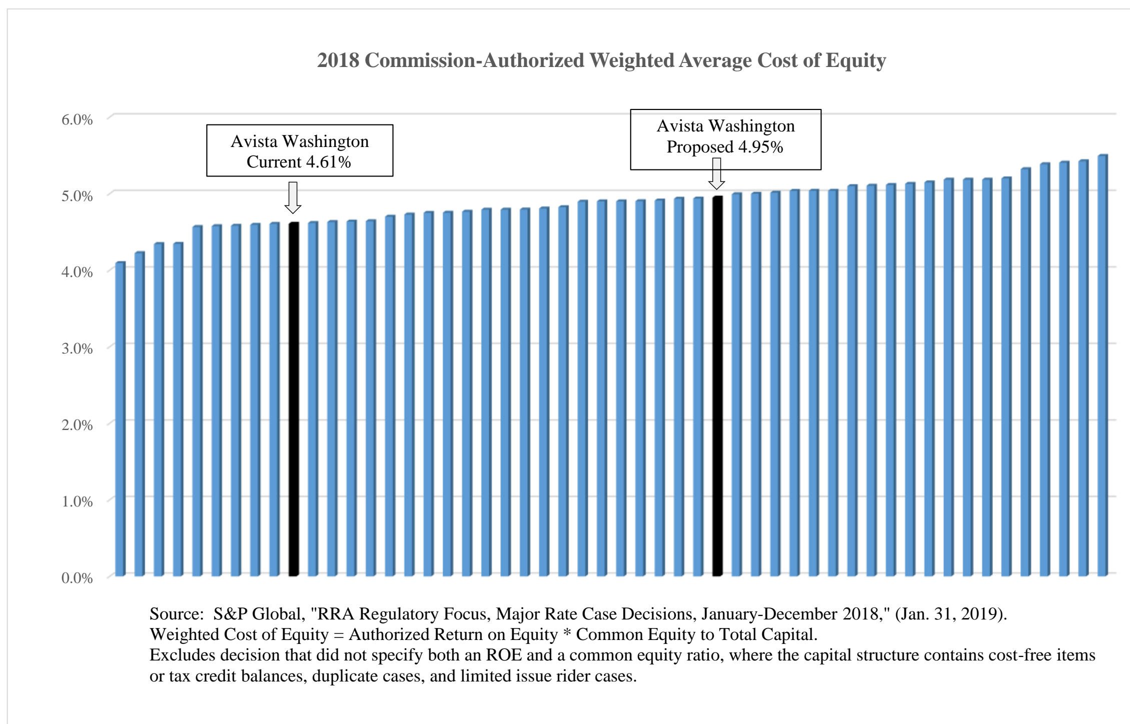


19 If the Commission simply carries over our existing ROE of 9.5 percent and 48.5
20 percent equity component, the weighted cost of equity would only be 4.61 percent, well below
21 even the midpoint of Illustration No. 4 above. In fact, Avista's proposed weighted cost of
22 equity puts very close to the midpoint.

1 **Q. In attracting capital under reasonable terms, is it necessary to attract**
2 **capital 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 December 31, 2018, we
5 had approximately $3.6 billion of long-term debt and equity. Approximately half of our
6 capital structure is funded by debt holders, and the other half is funded by equity investors
7 and retained earnings. Rating agencies and potential debt investors place significant emphasis
8 on maintaining credit metrics and credit ratings that support access to debt capital markets
9 under reasonable terms. Leverage – or the extent that a company uses debt in lieu of equity
10 in its capital structure – is a key credit metric and, therefore, access to equity capital markets
11 is critically important to long-term debt investors. This emphasis on financial metrics and
12 credit ratings is shared by equity investors who also focus on cash flows, capital structure and
13 liquidity, much like debt investors.
14 The level of common equity in our capital structure can have a direct impact on
15 investors' decisions. A balanced capital structure allows us access to both debt and equity
16 markets under reasonable terms, on a sustainable basis. Being able to choose among a variety
17 of financing methods at any given time also allows the Company to take advantage of better
18 choices that may prevail as the relative advantages of debt or equity markets can ebb and flow
19 at different times.
20 **Q. Are the debt and equity markets competitive markets?**
21 A. Yes. Our ability to attract new capital, especially equity capital, under
22 reasonable terms is dependent on our ability to offer a risk/reward opportunity that is equal to
23 or better than investors' other alternatives. We are competing with not only other utilities but

1 also with businesses in other sectors of the economy. Demand for our stock supports our stock
2 price, which provides us the opportunity to issue additional shares under reasonable terms to
3 fund necessary capital investments.

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

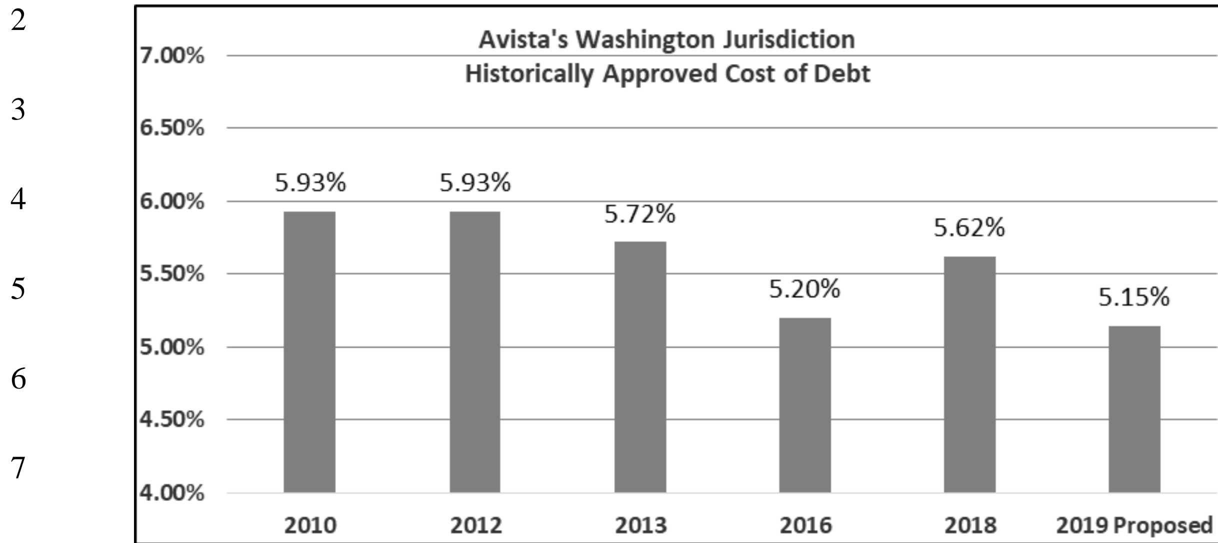
5 A. We are requesting a capital structure that provides us the opportunity to have
6 financial metrics that offer a risk/reward proposition that is competitive and/or attractive for
7 equity holders. We have steadily increased our dividend for common shareholders over the
8 past several years, which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

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

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

17 A. Our requested overall cost of debt is 5.15%. The authorized cost of debt has
18 trended downward for Avista from 2010 to 2016, with an uptick in 2018 due to low-cost debt
19 that rolled off in 2016, as shown in Illustration No. 5 below.

1 **Illustration No. 5:**



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

10 A. There has been a general decline in interest rates over the past decade. At the 11 same time Avista has issued new debt to fund capital expenditures and to replace higher cost 12 debt maturing, which has caused the Company's overall cost of debt to decrease. We have 13 been prudently managing our interest rate risk in anticipation of these periodic debt issuances, 14 which has involved fixed rate long-term debt with varying maturities, and executing forward 15 starting interest rate swaps to mitigate interest rate risk on a portion of the future maturing 16 debt and our overall forecasted debt issuances.

17 There is a decrease in the proposed cost of debt for 2019, as compared to 2018 18 authorized, due in part to the maturation of $272.5 million of debt with an average coupon of 19 6.93% and an effective yield of 8.425% during 2018.

20 From 2014 through 2018 the Company issued $800 million in long-term debt. The 21 weighted average interest rate of these issuances is 4.11%. These issuances have varying 22 maturities ranging from 30 years to 35 years. Our most recent issuance was funded on May

1 22, 2018. This issuance of $375 million of first mortgage bonds with a thirty-year maturity
2 was completed at a coupon rate of 4.35%. On the same day as the debt was priced, $275
3 million of interest rate swaps were settled. These swaps were entered into at various times in
4 accordance with the Company's Interest Rate Risk Management Plan (discussed in more
5 detail later in my testimony). The effective cost of this debt is 4.874%, including the issuance
6 costs and the cost of settled interest rate hedges. In May and June of 2018, we had debt
7 maturities that totaled $272.5 million with average yield of approximately 8.42%. This
8 reduced our overall cost of debt from 2018 to 2019 as shown in Illustration No. 5.[14]

9 We have continued to issue debt with varying maturities to balance the cost of debt
10 and the weighted average maturity. This practice has provided us with the ability to take
11 advantage of historically low rates. The Company's credit ratings have supported reasonable
12 demand for Avista debt by potential investors. We have further enhanced credit quality and
13 reduced interest cost by issuing debt that is secured by first mortgage bonds.

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

16 A. As mentioned earlier, we are forecasting $405 million (system) in capital
17 expenditures per year over the next five years. Additionally, we have $405.5 million of debt
18 maturing in a similar time frame. This results in a significant need for the issuance of long-
19 term debt, while maintaining an appropriate capital structure.

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[14] As provided by Ms. Andrews in Exh. EMA-1T, the actual 2018 cost of debt on an average-monthly-average (AMA) basis, per Washington Commission Basis Reports filed with the Commission on April 26, 2019, was 5.38%. Additional forecasted issuances in September 2019 brings the total cost of debt down to the 5.15% proposed in this filing.

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

7 We have continued to issue debt with varying maturities to balance the cost of debt
8 and the weighted average maturity. This practice has provided us with the ability to take
9 advantage of historically low rates on both the short end and long end of the yield curve.

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

15 In addition, the average life of plant assets for Avista exceeds 30 years. A 30-year
16 term for debt is a closer match to the average life of the underlying assets that are being
17 financed. Decisions on the term of the debt are generally made closer to the time that new
18 debt is issued. Based on information available today, although the Company will consider
19 some amount of 10-year debt in 2019, the issuances will likely be heavily weighted toward a
20 30-year term, due in large part to the matching of the financing to the life of the assets being
21 financed, and the narrow rate spread for 30-year vs 10-year terms.

1 The Company's credit ratings have supported reasonable demand for Avista debt by
2 potential investors. We have further enhanced credit quality and reduced interest cost by
3 issuing debt that is secured by first mortgage bonds.

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

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

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

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

19 A. Yes. In the Company's last general rate case (Dockets UE-170485 and UG-
20 170486), Commission Staff witness Mr. McGuire took issue with the Company's interest rate
21 hedging practices, recommending that "certain hedging losses" should be eliminated from the

1 Company's cost of debt, in essence proposing a disallowance of certain hedges.[15] The
2 Commission rejected Staff's proposal in Order 07, stating:

3 We accept Mr. Thies' assertions that the Company adhered to its Interest Rate
4 Risk Management Plan operational guidelines. Mr. Thies appropriately notes
5 the Plan was finalized in 2013 after consultation with Staff and has been
6 included as an appendix to his testimony in each GRC since that time, with
7 hedging settlements being included as part of the cost of capital calculations.[16]
8

9 **Q. Did the Commission give guidance in as to how the Company should hedge**
10 **interest rates in the future?**
11 A. Yes. In Order 07, the Commission agreed with Mr. McGuire that "the
12 Company is expected to apply to its interest rate hedges the risk mitigation approach as
13 provided in the March 2016 [natural gas] policy statement."[17]
14 **Q. Before discussing more recent changes to the Company's Interest Rate**
15 **Risk Management Plan, were the hedges that are included in the Company's cost of debt**
16 **in this filing consistent with the same hedging plan that the Company operated under in**
17 **its last general rate case?**
18 A. Yes. The hedges included in this filing were entered into a manner that is
19 consistent with the Company's Interest Rate Risk Management Plan in effect in Dockets UE-
20 170485 and UG-170486 and were approved by the Commission. The Company has executed
21 interest rate swaps, for purposes of reducing interest rate risk for our customers as early as
22 2004 and has been fully transparent in communicating its interest rate hedging activities. The
23 settlement values, either losses or gains, of the interest rate swaps have been clearly included
24 as a component of cost of debt in previous filings and this filing.

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

1 **Q. Has the Company made any recent changes to the Interest Rate Risk**
2 **Management Plan?**
3 A. Yes. After the issuance of the "Policy and Interpretive Statement on Local
4 Distribution Companies' Natural Gas Hedging Practices" (Policy Statement) in Docket G-
5 132019 related to natural gas hedging, Avista has instituted natural gas risk responsive
6 hedging. As Company witness Ms. Morehouse discusses in Exh. JM-1T, on August 31, 2018,
7 the Company filed its 2018 Washington Natural Gas Hedge Report and Exhibits (Docket UG-
8 180734) in accordance with the requirements of UG-132019. That report and associated
9 exhibits are provided as Exh. JM-3. Since the issuance of the Policy Statement, Avista
10 developed and tested a "Risk Responsive Hedging Tool" which integrates the use of Value at
11 Risk analysis for natural gas hedging purposes. As a direct result of that work on the natural
12 gas side, on January, 1, 2019, the Company added a Risk Responsive Hedging component to
13 its existing Interest Rate Risk Management Plan.
14 The interest rate Risk Responsive Hedging component employs Value at Risk (VaR)
15 calculations to further monitor and respond to dramatic interest rate volatility for unhedged
16 forecasted debt issuances. Risk Responsive Hedging is in effect for the two forward calendar
17 year's debt issuances. In conjunction with implementing this new component, the Company
18 reduced the Minimum Hedge Ratio for its existing Dynamic Window Hedging component to
19 40%. The Company believes that Risk Responsive Hedging is an additional protection for
20 customers against extreme market swings associated with the interest rate market. The
21 Company executed its first hedge under the newly implemented Interest Rate Risk
22 Management Plan in April 2019; however, this particular hedge was not a Risk Responsive
23 Hedge.

1 It is important to note that Avista only in the past five months has instituted risk
2 responsive hedging in compliance with the Policy Statement. Within two months of deploying
3 this on the natural gas side, similar risk responsive hedging analysis was deployed on the
4 interest rate side. Up to that point, however, the Company was continuing to follow the then-
5 current Interest Rate Risk Management Plan. The most current Interest Rate Risk
6 Management Plan has been included as Exh. MTT-3.

7 **Q. Turning now to return on equity ("ROE"), the Company is requesting a**
8 **9.9 percent ROE. Please explain why the Company believes this is reasonable.**

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

15

16 **VI. CREDIT RATINGS**

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

18 A. We have a five-year credit facility in the amount of $400 million with a
19 maturity date of April 18, 2021. The credit facility involves participation by ten banks. This
20 credit facility was originally established in 2011 and it was amended in April 2014 and
21 extended in May 2016. Our credit facility provides the ability to take out or repay short-term

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

1 debt based on day-to-day liquidity needs and to have letters of credit issued on the Company's
2 behalf. The Company pays fees under three price elements in the agreement: 1) a facility fee
3 to maintain the right to draw on the credit facility at any time, 2) interest on amounts borrowed,
4 and 3) fees for letters of credit.

5 The Company may request letters of credit (LCs) underwritten by the participating
6 banks and established for the benefit of counterparties to Avista. LCs are often used as
7 collateral when required for energy resources forward commitments, forward swap
8 transactions to hedge interest rate risk on future long-term debt, and other contractual or legal
9 requirements that involve the Company. The maximum amount available for LCs is $200
10 million. The amount available for cash borrowing out of the overall $400 million credit
11 facility is reduced by the amount of LCs outstanding. Table No. 4 below summarizes the rates
12 paid to maintain and use the credit facility.

13 **Table No. 4 – Credit Facility Fees (2014 Second Amendment to the 2011 Avista**
14 **Corporation Credit Agreement)**
15

Pricing Level	Facility Fee	Eurodollar Margin (1)	ABR Margin (2)	LC Participation Fee
I	0.075%	0.675%	0.000%	0.675%
II	0.100%	0.775%	0.000%	0.775%
III	0.125%	0.875%	0.000%	0.875%
IV	0.175%	0.950%	0.000%	0.950%
V	0.200%	1.050%	0.050%	1.050%
VI	0.250%	1.250%	0.250%	1.250%

Borrowing may be either of two types of short-term loans at the Company's discretion:

(1) Borrowing with a Eurodollar-based interest rate requires three days notice. Interest rate is based on the London interbank offered rate (LIBOR) plus a margin.
(2) Borrowing under the alternative borrowing rate (ABR) may be completed on the day requested. ABR interest rate is the prime rate set by the administrative agent bank plus a margin.

16 17 18 19 20 21 22 23 24

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

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

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

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

1 A. Avista' credit ratings, assigned by Standard & Poor's (S&P) and Moody's
2 Investor Service (Moody's) are as follows:
3
4
5

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

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

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

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

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

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

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

9 **Illustration No. 6**

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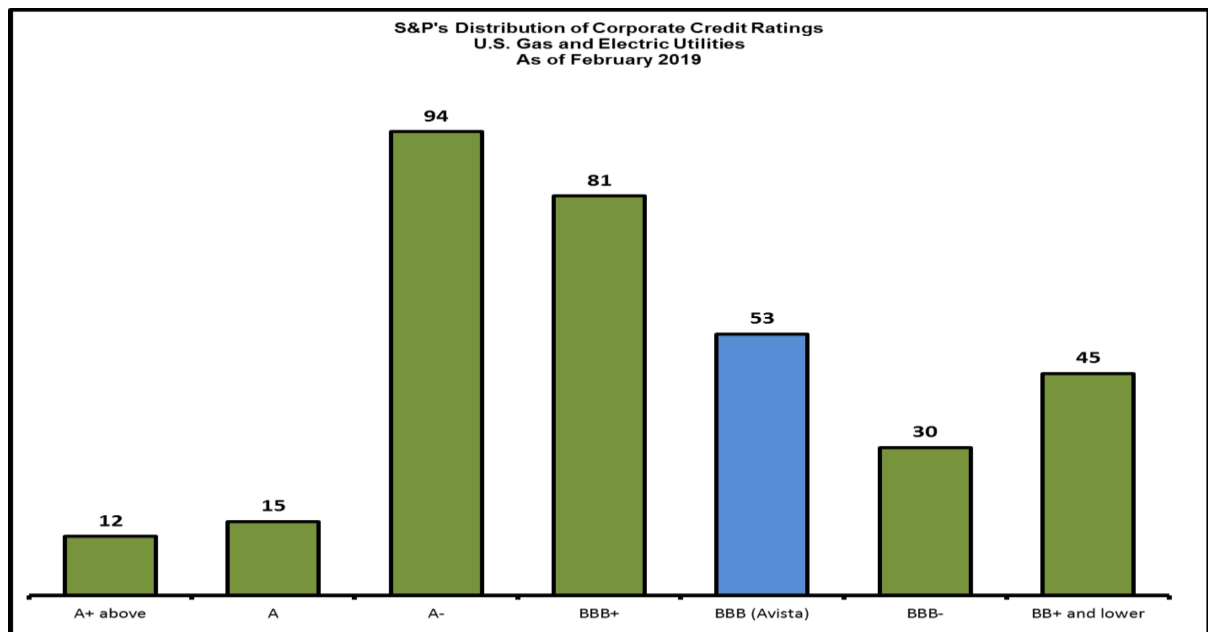

19 We expect that a continued focus on the regulated utility, conservative financing
20 strategies and a supportive regulatory environment will contribute toward an upgrade to a
21 BBB+ corporate credit rating for Avista. Operating with a BBB+ credit rating would likely
22 attract additional investors, lower our debt pricing for future financings, and make us more
23 competitive with other utilities. In addition, financially healthy utilities are better able to

1 invest in the required infrastructure over time to serve their customers, and to withstand the
2 challenges facing the industry and potential financial market disruptions.
3 **Q. Does this conclude your pre-filed direct testimony?**
4 A. Yes.