

Exhibit No. ____ -CT (KLE-1CT)
Docket Nos. UE-070804 et al.
Witness: Kenneth L. Elgin
REDACTED VERSION

BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Complainant,

vs.

AVISTA CORPORATION,

Respondent.

DOCKET NO. UE-070804

DOCKET NO. UG-070805

In the Matter of the Petition of

AVISTA CORPORATION d/b/a
AVISTA UTILITIES,

For an Accounting Order Regarding the
Appropriate Treatment of the Net Costs
Associated with the Purchase of Debt.

DOCKET NO. UE-070311

TESTIMONY OF

Kenneth L. Elgin

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

October 17, 2007

REDACTED PER PROTECTIVE ORDER

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I. INTRODUCTION.

Q. Please state your name and business address.

A. My name is Kenneth L. Elgin. My business address is 1300 South Evergreen Park Drive Southwest, Olympia, Washington, 98504-7250. My email address is kelgin@utc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I am employed by the Regulatory Services Division of the Washington Utilities and Transportation Commission as the Case Strategist.

Q. Please describe your education and relevant employment experience in public utility regulation.

A. I earned a Bachelor of Arts degree from the University of Puget Sound in 1974, and I earned a Master of Business Administration degree from Washington State University in 1980. In January 1985, I began my employment in public utility regulation with the Commission as a Utilities Rate Research Specialist for the Utilities Division. In that initial assignment I worked primarily on financial analysis and rate of return issues for all regulated utilities. I was also responsible for natural gas issues as the industry restructured in response to changes in federal regulatory policy.

1 In December 1989, I was promoted to the position of Assistant Director for
2 Energy as part of the reorganization of the Utilities Division. In that capacity, I was
3 responsible for the policy direction of the Utilities Division's electric and natural gas
4 programs, which included the natural gas safety program.

5 In 1995, I assumed my present position as Case Strategist for the Utilities
6 Division. In this current assignment, I consult with or represent Staff on all aspects
7 of energy cases presented to the Commission in the context of litigation. I am also a
8 resource for other sections in the Utilities Division in contested proceedings before
9 the Commission performing financial analysis of regulated operations under RCW
10 Titles 80 and 81.

11 I have testified before the Commission on many occasions. Exhibit No. ____
12 (KLE-2) is a table listing the contested cases in which I have presented testimony in
13 litigation. I testified before the Federal Energy Regulatory Commission on issues
14 related to rate design, capital structure, and risk for interstate natural gas pipelines. I
15 testified on several occasions in Superior Court as an expert in the regulation of
16 investor-owned utilities, including issues of rate of return and valuation under the
17 public service laws, as administered by the Commission pursuant to RCW Titles 80
18 and 81. I have also testified as an expert witness for the Washington State
19 Department of Revenue in arbitrations concerning valuation and energy industry
20 restructuring.

21 I have been the lead analyst for numerous tariff filings, and in that capacity I
22 have presented Staff recommendations to the Commission at its regular open public

1 meetings. Finally, I have made numerous studies of the cost of capital for energy
2 companies in contested rate proceedings leading to a settlement of this issue.

3 During my 22-plus years of experience working on energy and financial
4 issues, I have developed a thorough working knowledge of both the operational and
5 financial profiles of jurisdictional energy utilities.

6
7 **Q. Have you prepared any other exhibits in support of your testimony?**

8 A. Yes. I have prepared Exhibit Nos. ____ (KLE-2) through (KLE-4), which I describe
9 later in my testimony.

10
11 **Q. What is the scope of your testimony?**

12 A. My testimony addresses Avista's cost of trust preferred stock and debt in the
13 calculation of its overall cost of capital for ratemaking purposes. Avista also
14 proposes to include in its cost of preferred and debt the amortization of deferred
15 items currently on its balance sheet. I provide a recommendation for the proper rate
16 treatment of those amounts in the cost of preferred and debt calculations.

17
18 **Q. How is your testimony organized?**

19 A. First, I provide a calculation of the cost of trust preferred stock. *Exhibit No. ____*
20 *(KLE-3)*. Second, I calculate the cost of debt and describe the adjustments to the
21 Company's calculation. Next, I analyze the amortization of deferred amounts Avista
22 is proposing to recover in the cost of debt calculation. *Exhibit No. ____ (KLE-4)*.

1
2 **II. SUMMARY.**
3

4 **Q. Please summarize your analysis of the Company's proposed cost of debt and**
5 **trust preferred equity.**

6 A. The Company's calculation for the cost of its trust preferred and debt securities is
7 overstated. There are two primary reasons for this fact. The most significant item is
8 its proposal to limit the *pro forma* calculation for the cost of debt as of December 31,
9 2007. See Exhibit No. ____ (MKM-1T), 20:20-211; and Exhibit No. ____ (EMA-3),
10 1:42. It is not a *pro forma* cost of debt calculation consistent with all other *pro*
11 *forma* adjustments Avista proposes for the 2008 rate year. Limiting the *pro forma*
12 adjustment overstates interest costs expected in the 2008 rate year. The Company's
13 calculation is also inconsistent with Commission policy, which requires adjusting
14 debt and preferred costs when known changes are expected to occur in the rate year.
15 My calculations are consistent with the 2008 rate year and prior Commission policy.

16 The second difference is the proper rate treatment in the cost of debt
17 calculation of deferred items on the Company's balance sheet. The Company is
18 proposing incorrect amounts for amortization of these deferred amounts. The
19 majority of these items were first considered in Avista's accounting petition
20 previously filed in Docket No. UE-070311. My recommendation requires Avista to
21 amortize deferred amounts in accordance with the Commission's accounting rules.

1 In addition, I have found other items in the calculation of the cost of debt that are
2 either improperly recorded or being amortized incorrectly by Avista.

3 Finally, with respect to the cost of preferred, Avista reclassified amounts
4 previously recorded in an account for costs associated with issuing stock to an
5 account associated for recording debt costs. It did so without Commission authority.
6 It then proposes to recover these amounts in the cost of trust preferred. These
7 adjustments must be reversed.

8
9 **Q. Please state the result of your analysis and proposed cost of trust preferred and**
10 **debt for Avista in this case.**

11 A. My analysis shows that the Company's cost of trust preferred is 6.575 percent. Its
12 *pro forma* cost of debt for the 2008 rate year is estimated to be 6.491 percent.

13
14 **III. DISCUSSION & ANALYSIS.**

15
16 **A. Cost of Trust Preferred Equity.**

17
18 **Q. Please explain how you determined that the cost of trust preferred equity is**
19 **6.575 percent.**

20 A. The difference is due to a single issue: Avista transferred amounts previously
21 recorded in account 214 (Capital Stock Expense) to account 189 (Unamortized Loss
22 on Reacquired Debt).

2 **Q. What are the amounts Avista reclassified between these accounts and proposes**
3 **to include in the cost of trust preferred stock?**

10

13 A. Avista's proposal reduces the net proceeds from the Series B & C trust preferred
14 securities by these amounts. The effect of the proposed treatment increases the cost
15 of the Series B & C trust preferred to 7.037 percent.

16

18 A. The Commission should reject the proposal. There is no authority in the Uniform
19 system of Accounts (“USOA”) for the proposed treatment. Transferring amounts
20 from account 214 to account 189 requires an order from the Commission, which
21 Avista did not request or receive. Therefore, it is improper to recover these costs as

1 proposed by Avista in the cost of trust preferred equity. Avista should be ordered to
2 reverse this entry in its books.

3 Exhibit No. ____ (KLE-3) contains the calculation I propose for the trust
4 preferred after removing the amounts that were transferred between accounts by
5 Avista without Commission authority.
6

7 **B. Cost of Debt.**
8

9 **Q. Please summarize the difference between the Company's proposed cost of debt**
10 **and the analysis you performed for this calculation.**

11 A. The Company is proposing a cost of debt of 7.701 percent. My analysis indicates
12 that a reasonable estimate of the cost of debt for setting rates in this case for the 2008
13 rate year is 6.491 percent.
14

15 **Q. Have you prepared an exhibit showing the estimated cost of debt you propose**
16 **for this case?**

17 A. Yes. Exhibit No. ____ (KLE-4) is a four-page document supporting the cost of debt I
18 recommend for ratemaking purposes. It includes all the adjustments I discuss later in
19 my testimony.
20

1 **Q. Please explain the principles underlying your cost of debt calculation?**

2 A. The cost of debt calculation I recommend is a true *pro forma* calculation consistent
3 with all other *pro forma* rate making adjustments for the 2008 rate year. Indeed, the
4 Company's presentation in its direct case is premised upon a 2008 rate year. *See*
5 *Exhibit No. ____ -T (SLM-1T), 9:21-22*. Avista inexplicably advocates that its cost of
6 debt is based on a "*pro forma*" cost as of December 31, 2007. The testimony and
7 exhibits on this point provide no explanation for the inconsistency of its cost of debt
8 calculation with all other *pro forma* rate year accounting adjustments.

9 The second principle in my calculation centers on the proper treatment of
10 various deferred items on the Company's balance sheet, and the amortization of
11 those items in the calculation of the cost of debt consistent with the USOA.

12

13 **Q. Please explain why the proposal to limit the pro forma cost of debt calculation**
14 **to December 31, 2007, explains the significant difference between your**
15 **calculation and that of Avista.**

16 A. Using December 31, 2007, to stop Avista's *pro forma* adjustments fails to remove
17 \$272,860,000 of 9.75 percent Senior Notes on June 1, 2008, that will retire on June
18 1, 2008. If the *pro forma* calculation is limited to December 31, 2007, the cost of
19 debt calculation overstates rate year costs. This adjustment is necessary in order to
20 be consistent with Avista's own asserted use of a 2008 *pro forma* rate year
21 calculation of revenue requirements. *Exhibit No. ____ (KLE-4) at 3:98*.

22

1 **Q. Are there any other reasons why you believe this *pro forma* adjustment to the**
2 **cost of debt calculation is proper?**

3 A. Yes. It is consistent with prior Commission practice. In prior cases, the Company
4 advocated including projections of both refunding activities and new debt expected
5 to be issued in the rate year. The Commission accepted this concept, and it has
6 required an update to reflect rate year costs when changes in debt costs are expected
7 to occur in the rate year. *See Cause No. U-84-28, Second Supplemental Order at 28;*
8 *Cause No. U-85-36, Third Supplemental Order at 37.*

10 **Q. Are there any other debt series for Avista that should be removed for purposes**
11 **of a proper *pro forma* cost of debt calculation?**

12 A. Yes. Two additional \$10,000,000 notes in the Series A will mature in June 2008. I
13 remove these two notes and the costs associated with them in the calculation.
14 *Exhibit No. ____ (KLE-4) at 1:5-8.*

15 The final *pro forma* adjustment related to retirements removes the
16 amortization of costs for the Series B Medium Term Note that mature on June 30,
17 2008. Annual amortization expense of these costs is \$16,112 annually. *Exhibit No.*
18 *____ (KLE-4) at 2:72.*

19

1 **Q. Now that you’ve adjusted the pro forma calculation for known retirements, did**
2 **you include any estimates of the costs associated with the new debt in Avista’s**
3 **capital structure to account for the maturing 9.75 percent Senior Notes or the**
4 **two maturing Series A First Mortgage Bonds?**

5 A. Yes. For purposes of this case, I make *pro forma* adjustments to Avista’s cost of
6 debt to account for the estimated cost of new long-term debt it plans to issue in 2008.

7
8 **Q. What specific adjustments do you make for the fact that these securities will**
9 **mature in 2008?**

10 A. Avista’s financial forecast indicates that it will issue approximately [REDACTED] of
11 new long-term debt in 2008.

12
13 **Q. Do you have any evidence of the cost to Avista if it were to issue new long-term**
14 **debt in June 2008?**

15 A. Yes. Mr. Malquist’s work paper shows what Avista has been able to achieve
16 recently when issuing new debt. In December 2006, Avista sold \$150,000,000 of
17 new secured 30-year notes with a 5.70 percent coupon. In November 2004, Avista
18 sold \$90,000,000 of 15-year notes with a 5.45 percent coupon. *Exhibit No. ____*
19 *(KLE-4) at 1:31 and 41.*

20 I also reviewed data showing recent corporate bond yield averages published
21 by Moody’s. It summarizes pricing data for long-term bonds with amounts in excess
22 of \$100 million. It shows in December 2006 “Baa” utility bonds averaged 6.05

1 percent, at the time Avista achieved 5.70 percent on its offering. The current data
2 indicates “Baa” bonds are now averaging 6.51 percent. Based upon this data and
3 other data I have reviewed, I consider 6.50 percent a reasonable estimate for
4 purposes of this case. *Exhibit No. ____ (KLE-4) at 3:132.*

5
6 **Q. Are there any other adjustments to the cost of the new security Avista plans to**
7 **issue in 2008?**

8 A. Yes. First, I estimate that the costs associated with issuing the new bond will be
9 approximately \$1.3 million. This amount is similar to the costs Avista incurred
10 when issuing its first mortgage bonds at the end of 2006. *Exhibit No. ____ (KLE-4) at*
11 *1:31.*

12 Second, Avista executed two hedges for the maturing 9.75 percent series
13 notes; both were 10-year hedges in the amount of \$50 million and \$75 million.
14 Since interest rates have fallen, the hedges are “not in the money.” If interest rates
15 do not change between now and mid-2008, when Avista issues new debt, the
16 Company expects to make payments to the counterparty to settle hedges in 2008.

17 In September 2007, Avista’s valuation from the counterparty on its current
18 hedge exposure is: 1) \$723,703 for the \$50 million hedge; and 2) \$4,204,521 for the
19 \$75 million hedge.
20

1 **Q. What is your recommendation for treating the expected costs to Avista for**
2 **settling the hedge in your pro forma debt adjustment in this case?**

3 A. It is reasonable to include an estimate of the cost of the hedges in the pro forma cost
4 of debt calculation consistent with the estimated costs of issuing new long-term debt.
5 My calculation assumes Avista will issue 30 year bonds in 2008. Therefore, I have
6 included in the *pro forma* cost calculation an estimate of the amortization expense
7 for each hedge. This amount is \$24,123 and \$140,150 for the \$50 million and \$75
8 million hedge, respectively. *Exhibit No. ____ (KLE-4) at 3:133-134.*

10 **Q. What additional comments do you have with respect to the issue concerning the**
11 **hedges for the 9.75 percent Series that matures in June 2008?**

12 A. I have two comments. First, the settlement payment and its actual amortization
13 schedule will be dependent upon the securities Avista sells in 2008. I propose
14 estimates designed to provide some recovery of the cost of the hedges in the *pro*
15 *forma* calculation for the 2008 rate year. Avista is expected to manage its maturity
16 schedule in order to minimize its cost of debt. If a different set of maturities for the
17 new debt is necessary, Avista must match the amortization to the life of the securities
18 it issues in 2008. The Commission is not locked into any specific treatment for these
19 costs in the next rate case. The actual settlement payment and the amortization
20 schedule will be adjusted for the securities Avista issues in 2008.

21 Second, Staff reserves the right to evaluate the prudence in the next rate case
22 for these hedges. Its recommendation is based upon a presumption that the

1 execution of the hedge was prudent. Due to the fact that the existence of the hedges
2 was not part of the direct case, Staff will investigate the prudence of the hedges in
3 the next rate case.

4
5 **Q. What estimate for future short-term interest rates did you use for Avista**
6 **intends in 2008?**

7 A. I accept Avista's proposed cost of its short-term debt, estimated to be 5.75 percent.
8 *Exhibit No. ____ (KLE-4) at 3:131.*

9
10 **C. Deferred Items in the Cost of Debt Calculation.**

11
12 **Q. Will you please summarize the other items you found in the Company's**
13 **presentation that are incorrect?**

14 A. Yes. The first item is in response to the Company's direct testimony of Ms.
15 Burmeister-Smith. *See Exhibit No. ____ -T (CMBS-1T).* It involves amounts on
16 Avista's books associated with its open market purchases of debt between 2002 and
17 2006, and the amortization of those costs in its cost of debt calculation. *See Docket*
18 *No. UE-070311.*

19 The second area involves other amounts deferred by Avista, and its proposal
20 to include the amortization of those deferred items in the cost of debt calculation.

1 **Q. Please summarize the testimony of Avista on the issue of debt repurchase costs**
2 **and the accounting involving these costs.**

3 A. The Company asserts that it relied upon Financial Accounting Standard No. 71
4 (“FASB 71”) as the basis for its accounting treatment. It also states that the
5 amortization of the deferred amounts is not unreasonable, even though it
6 acknowledges that it did not follow the Commission’s rules for recording the
7 amortization expense.

8

9 **Q. Is the Company correct in its assertion that FASB 71 provides the basis for the**
10 **accounting treatment it is using for recognizing the expense of the deferred**
11 **amounts on its books associated with the debt repurchases?**

12 A. No. FASB 71 establishes the principle for recording regulatory assets on the books
13 of utilities, if there is reasonable assurance that future rates will recover the deferred
14 amounts. If Avista recorded these costs consistent with the USOA and amortized the
15 regulatory asset in conformance with the USOA, FASB 71 applied since there is
16 reasonable assurance of future recovery of the asset. Once Avista choose to amortize
17 the costs differently than prescribed by the USOA for costs associated with its debt
18 repurchases, it is unclear whether FASB 71 continued to apply, allowing Avista to
19 record the asset on its books.

20

1 **Q. Why do you state that it is unclear whether FASB 71 continued to apply?**

2 A. An accounting order from the Commission is the key element authorizing different
3 treatment than prescribed by the USOA, and such an order clearly would have
4 enabled Avista, under FASB 71, to continue to record the amount of the regulatory
5 asset on its books. Without an accounting order from the Commission authorizing
6 the amortization schedule used by Avista, it is unclear whether Avista should have
7 continued to record the regulatory asset under FASB 71.

8

9 **Q. Avista asserts that the decision it made with respect to these repurchase costs is**
10 **reasonable. What is your conclusion regarding Avista's decision to extend the**
11 **period of recovery of the deferred item on its balance sheet for debt costs?**

12 A. I don't think it is appropriate for Avista to assert at this time its decision was
13 reasonable. The determination of reasonable treatment, *i.e.*, public interest, is
14 evaluated by the facts and circumstances facing the Company and its customers at
15 that time Avista began its repurchase program. In particular, the analysis provided
16 by Avista is faulty in one critical respect: it fails to show how the amortization
17 schedule it chose balances benefits with the costs.

18

1 **Q. Have you completed an analysis to determine the level of benefits associated**
2 **with the debt repurchases and the costs to achieve these benefits?**

3 A. In response to Staff Data Request 26, Avista shows that in 2002 alone the interest
4 savings of the repurchases were almost \$18 million. In 2003, interest savings were
5 \$1.8 million, and in 2004 interest savings were \$943,000.

6 The cumulative benefits to Avista, net of costs, were \$16 million, \$1.7
7 million, and \$0.6 million from 2002 through 2004, respectively.

8

9 **Q. Do these savings impact the determination of whether the amortization schedule**
10 **chosen by Avista is reasonable?**

11 A. Absolutely. If Avista filed its accounting petition in 2002 when Avista began
12 executing the repurchase program, the Commission and other parties would have
13 considered the savings from the repurchase program and evaluated Avista's proposal
14 to extend the amortization of the costs. The near-term savings from the repurchases
15 in 2002 would have been a material issue in the Commission's consideration as to
16 whether not only to extend the amortization period but for how long the amortization
17 period should be.

18

19 **Q. Why would it be reasonable to argue at that time the benefits of the repurchase**
20 **strategy and costs be deferred?**

21 A. Consider the circumstances facing Avista and its customers in 2002. Avista just
22 obtained significant rate increases to pay for deferred power costs. It also financed

1 those deferred power costs at high interest rates, *i.e.*, the 9.75 percent unsecured note.

2 Therefore, a strong argument could have been made that the benefits of the
3 repurchases should be deferred along with the costs to achieve these savings.

4 Unfortunately, no party had the chance to advocate that position or any other
5 position for the treatment of the costs and benefits from the repurchase program, nor
6 did the Commission have the opportunity to evaluate the specific circumstances
7 facing Avista in order to make an informed public interest determination.

8 It is impossible for the Commission to reconstruct the past and determine what it
9 would have done under those circumstances.

10

11 **Q. The Company asserts that the amortization schedule it chose does not alter the**
12 **amount of the expense, only the timing. What is your response to that analysis?**

13 A. Avista's analysis is too narrow. It only looks at the total amortization amount. A
14 more complete analysis would consider the timing of the benefits realized by Avista
15 in repurchasing the debt in conjunction with the amortization schedule to recognize
16 the costs.

17

18 **Q. The Company asserts that Idaho and Oregon have approved Avista's**
19 **accounting for deferred repurchased costs. What is your response to this**
20 **assertion?**

21 A. This argument is not compelling. In both states, it was an uncontested issue.

22

1 **Q. The Company asserts that it used the same accounting in prior Washington**
2 **cases. Do you have any comments regarding this assertion?**

3 A. The issue simply wasn't raised by any party. Second, the prior cases all involve
4 settlements. In Avista's most recent rate case (Docket Nos. UE-050482/UG-
5 050483), the settlement contains a provision that states, "... (no party has) consented
6 to the facts, principles, methods or theories employed in arriving at the Settlement
7 Agreement, and ... no Signing Party shall be deemed to have agreed that such a
8 Settlement Agreement is appropriate for resolving any issues in any other
9 proceeding."

10 In conclusion, settlements do not establish precedent for any issue in a
11 contested proceeding.

12
13 **Q. The Company asserts that Staff questioned the Company's methodology for**
14 **accounting for the debt repurchases in Avista's 2004 rate case, but it did not**
15 **recommend a different accounting treatment at that time. What is your**
16 **response to this assertion?**

17 A. As I have already stated, the 2004 gas rate case resulted in a settlement; it did not
18 establish any precedent for a future rate case. Second, I was the analyst reviewing
19 the cost of capital in that case. The issue I raised at the time was unrelated to the
20 accounting treatment of the deferred debt costs. My inquiry involved the cost of debt
21 for the 9.75 percent series, its relationship to the new adopted resource recovery
22 mechanism ("ERM") with its explicit carrying costs for deferred balances, and

1 whether the ERM carrying charges should act as an offset to the high cost of the 9.75
2 percent Series. I was concerned whether there was double recovery of the debt
3 costs—once in the ERM carrying charge, and then again in a below-the-line
4 calculation of rate of return. At that time, the issue of improper accounting never
5 was raised.

6
7 **Q. Are there any other comments you have with respect to the Company's**
8 **treatment of the deferred amounts for debt repurchases and the decision to**
9 **amortize these amounts in a manner other than that prescribed by the USOA?**

10 A. Yes. When I first uncovered the issue, I made inquiries to the treasurers of each
11 regulated utility in Washington. The discussions involved their understanding of the
12 USOA and debt repurchases. There was universal agreement regarding the treatment
13 of debt repurchases, if no new security is issued: the costs are amortized over the life
14 of the original security or immediately expensed, consistent with the requirements of
15 the USOA.

16
17 **Q. Please summarize your conclusion with respect to this particular issue?**

18 A. Avista's proposed amortization of the amounts it deferred in its debt repurchase
19 program should be rejected. The Commission should order Avista to follow the
20 USOA and amortize the costs over the remaining life of the outstanding securities. I
21 have removed virtually all costs and benefits associated with the repurchases for 9.75

1 percent Series Notes from the cost of debt calculation since they do not conform to
2 the USOA. *Exhibit No. ____ (KLE-4) at 3:104-118.*

3
4 **Q. What is your recommendation for recovery and amortization associated with**
5 **Avista's debt repurchase strategy, and the resolution of the issues presented in**
6 **Docket No. UE-070311?**

7 A. In a supplemental response to Staff Data Request No. 70, Avista presents evidence
8 that its financial officers were planning to issue new debt in 2004. In the
9 presentation to Avista's Board of Directors ("Board"), management stated that it
10 intended to use the proceeds from the new for several different items. One of the
11 items included open market repurchases of outstanding debt. Management obtained
12 approval from the Board issue the securities and to use the proceeds to manage its
13 cost of debt. It is arguable that Avista could have tied its repurchases from that point
14 in time to specific new long-term debt it eventually issued.

15 Avista provided a schedule showing that, for a 12-month period between
16 February 2004 and 2005, it made approximately \$7.5 million of debt repurchases
17 that it could reasonably tie to these newly issued securities. During that time frame,
18 Avista issued two new securities: \$90 million of 5.45 percent; and \$150 million of
19 6.25 percent secured notes. *Exhibit No. ____ (KLE-4) at 1:39 and 44.*

1 **Q. What is the treatment you recommend for these repurchases in this time**
2 **period?**

3 A. I recommend that the costs of the repurchases be recorded in conformance with the
4 USOA. Avista should be authorized to defer and amortize the premiums it paid to
5 repurchase approximately \$52 million of high-cost debt over the life of these two
6 specific securities.

7 Therefore, I have included \$304,286 and \$35,630 (Washington allocated
8 share) in the calculation of the total cost associated with each of these notes in order
9 to recover those costs over the life of the now long-term debt Avista issued in 2004
10 and 2005. *Exhibit No. ____ (KLE-4) at 1:42 and 48.*

11

12 **Q. Is this Staff's recommendation to the issues presented in Docket No. UE-070311,**
13 **which are part of this proceeding?**

14 A. Yes. It resolves all remaining issues in that docket.

15

16 **Q. Are there any other adjustments to the cost of debt you made for purposes of**
17 **ensuring that there are proper levels of amortization expense associated with**
18 **Avista's debt repurchases, consistent with the USOA?**

19 A. Yes. For the repurchases associated with the Series A Secured Medium Term Notes,
20 I adjust the amortization of the deferred amounts for three individual repurchases in
21 accordance with the USOA. The deferred amounts are: \$534,070, \$396,981, and
22 \$122,626. Avista is incorrectly amortizing these amounts through 2015 at the rate of

1 \$102,798 for all three notes. The correct annual amortization amounts for the notes
2 are: 1) \$ 39,561 through 2018 for the \$534,070 deferred amount; 2) \$21,266 through
3 2023 for the \$396,981 deferred amount; and 3) \$6,569 through 2023 for the
4 \$122,626 deferred amount. *Exhibit No. ____ (KLE-4) at 1:20-22.*

5 For the repurchases associated with the Series B Medium Term Notes, I
6 adjust the amortization of the deferred amounts for two repurchases in accordance
7 with the USOA. The deferred amounts are: \$184,019 and \$458,998. The correct
8 amortization amounts for the notes are: 1) \$8001 through 2023 for the \$184,019
9 deferral amount; and 2) \$20,287 through 2022 for the \$458,998 deferral amount.
10 *Exhibit No. ____ (KLE-4) at 2:80-81.*

11 The other adjustment for the Series B involves the amortization of \$276,594
12 of Series Costs at the rate of \$16,112 per year. The work paper shows the series
13 matures in June 2008. Therefore, the amortization expense should be removed to be
14 consistent with all other *pro forma* adjustments. *Exhibit No. ____ (KLE-4) at 3:77.*

15 The final adjustment to the amortization of deferred amounts involves
16 settlement payments Avista received in the amount of \$2,350,000 and \$407,637 as
17 part of its repurchase program. Avista proposes to amortize the benefits over the
18 average life of its outstanding securities. This, too, is incorrect. The amortization
19 schedule should also match the original maturity dates of the underlying securities,
20 June 2028 and December 2022, respectively. Therefore, the annual amortization of
21 these payments to Avista is \$102,174 and \$20,727 respectively. *Exhibit No. ____*
22 *(KLE-4) at 3:98-99.*

1

2 **Q. Please state if there are any other issues you found with the cost of debt**
3 **calculations proposed by Avista.**

4 A. Yes. There are three other issues to address. The first involves the proper treatment
5 of hedges for cost of debt calculations. Due to the fact that Avista has a significant
6 amount of debt in its capital structure maturing in 2007 and 2008, it chose to hedge a
7 portion of its future interest costs to mitigate its refinance risk. See *Exhibit No. ____*
8 *T (MKM-1T), 14:3-22*. Avista is not treating the costs of the hedges correctly.

9 The second issue involves costs Avista deferred treatment associated with a
10 convertible security it never issued.

11 The final issue involves costs associated with Avista's five-year \$350 million
12 line of credit.

13

14 **Q. Please state what you believe to be the proper rate treatment for interest rate**
15 **swaps executed by any utility in order to manage future interest rate risk.**

16 A. Consistent with the USOA, deferred treatment of an interest rate swap, or hedge,
17 must be tied to the sale of a specific future security. The cost of the future security is
18 directly impacted by a decision to hedge future interest rate risk. Therefore,
19 assuming the execution of the hedge is prudent, it is proper to recognize the costs of
20 the hedge when the new security is sold. The Company did not connect the specific
21 hedge to the security Avista eventually issued. The work papers in support of the
22 cost of debt calculation have other errors as well. In some instances the hedge is

1 indirectly tied to the wrong security, and in other instances Avista used inconsistent
2 amortization schedules for both settlement payments and costs associated with
3 executing the hedge. My calculations correct these errors.

4
5 **Q. Please specify the corrections you recommend for rate treatment of hedges and**
6 **the correct treatment for the costs associated with executing a hedge.**

7 A. The first correction I make in the calculations involves a settlement payment to
8 Avista in the amount of \$1,502,769 associated with a fixed/variable hedge it
9 executed for \$25,000,000 of the 9.75 percent Series Unsecured Note. Consistent
10 with the *pro forma* calculation removing the maturing 9.75 percent note, it is proper
11 to remove the costs of the hedge and settlement payment of the hedge. *Exhibit No.*
12 *____ (KLE-4) at 3:104-105.*

13 The next correction involves the treatment of a \$75 million hedge associated
14 with the newly issued 6.25 percent Series B Secured Medium Term Note. Avista is
15 incorrectly amortizing \$261,351 of issuance costs over the life of the hedge rather
16 than the life of the new security. Correcting this error reduces the amortization
17 expense for issuance costs from \$6,181 to \$2,799. *Exhibit No. ____ (KLE-4) at 1:50.*

18 The last item in the work paper requiring correction is that Avista incorrectly
19 ties a hedge for \$75 million to Avista's \$45,000,000 6.125 percent Series B Secured
20 Note. The hedge impacts Avista's \$150,000,000 5.70 percent Series B Secured
21 Note. In addition, the Company is incorrectly amortizing over the life of the hedge
22 the deferred \$3,738,000 cash payment it made to settle the swap. The amortization

1 of the settlement payment should be over the 30 year life of the note, not the life of
2 the hedge. I have corrected this error. It reduces the amortization of the settlement
3 payment made by Avista from \$534,000 to \$124,600. I also correct the amortization
4 of the expense associated with the hedge from \$6,098 to \$1,863 to match the life of
5 the note. *Exhibit No. ____ (KLE-4) at 1:32-33.*

6
7 **Q. Please explain the treatment Avista is proposing for costs associated with its**
8 **convertible debt issue.**

9 A. Avista deferred \$247,406 in legal and other costs it incurred to evaluate the sale of a
10 convertible debt security and proposes to amortize these costs over nine years. This
11 treatment is incorrect. Since Avista did not issue a security, there is no basis for
12 deferring the costs and amortizing them in the calculation of the cost of debt. The
13 proper treatment is for Avista to record the costs as an expense. *Exhibit No. ____*
14 *(KLE-4) at 2:56.*

15
16 **Q. Please explain the costs Avista is proposing for deferred recovery related to its**
17 **commercial line of credit.**

18 A. Mr. Malquist's workpaper shows that Avista has been deferring costs associated with
19 executing its five-year commercial line of credit with various banks since 2004. The
20 Company proposes annual amortization of \$483,069 of deferred costs. The USOA
21 does not provide for the deferred treatment Avista proposes for these costs.

1 In evaluating this issue, it is important to note that utilities have recently been
2 able to arrange for credit agreements with banks for periods extending well beyond
3 one year. Avista has a five-year agreement with a syndicate of commercial banks for
4 its immediate short-term cash needs. The question now is whether it is reasonable to
5 defer the costs utilities incur to set up long-term credit arrangements. After
6 reviewing the potential alternative rate making options for these costs, Staff believes
7 deferred treatment and amortization of the costs over the life of the credit
8 arrangement is reasonable. *Exhibit No. ____ (KLE-4) at 3:137.*

9 Therefore, Staff recommends the Commission accept Avista's proposed
10 treatment of costs associated with its line of credit and authorize it to: 1) defer the
11 costs of establishing its long-term credit arrangements; and 2) amortize the deferred
12 costs over the life of the credit agreement.

13
14 **Q. Does that conclude your direct testimony?**

15 **A. Yes.**