

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-16_____

DOCKET NO. UG-16_____

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

4 A. My name is Mark T. Thies. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corporation as Senior Vice
6 President, Chief 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
15 gas service to areas of South Dakota, Wyoming and Montana. I joined Black Hills
16 Corporation in 1997 upon leaving InterCoast Energy Company in Des Moines, Iowa, where
17 I was the manager of accounting. Previous to that I was a senior auditor for Arthur
18 Anderson & Co. in 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 the proposed capital structure, overall rate of return, and our credit ratings. Additionally, I
22 will summarize our capital expenditures program. Mr. Adrien McKenzie, on behalf of
23 Avista, will provide additional testimony related to the appropriate return on equity for

1 Avista, based on our specific circumstances, together with the current state of the financial
 2 markets.

3 In brief, I will provide information that shows:

- 4 • Avista’s plans call for a continuation of utility capital investments in generation,
 5 transmission and distribution systems to preserve and enhance service reliability
 6 for our customers. Capital expenditures of approximately \$1.2 billion are
 7 planned for the three-year period ending December 31, 2018. Avista needs
 8 adequate cash flow from operations to fund these requirements and for
 9 repayment of maturing debt, together with access to capital from external
 10 sources under reasonable terms, on a sustainable basis.

- 11 • We are proposing an overall rate of return of 7.64 percent, which includes a 48.5
 12 percent common equity ratio, a 9.9 percent return on equity, and a cost of debt
 13 of 5.51 percent. We believe our proposed overall rate of return of 7.64 percent
 14 and proposed capital structure provide a reasonable balance between safety and
 15 economy.

- 16 • Avista’s corporate credit rating from Standard & Poor’s is currently BBB and
 17 Baa1 from Moody’s Investors Service. Avista must operate at a level that will
 18 support a solid investment grade corporate credit rating in order to access capital
 19 markets at reasonable rates. A supportive regulatory environment is an
 20 important consideration by the rating agencies when reviewing Avista.
 21 Maintaining solid credit metrics and credit ratings will also help support a stock
 22 price necessary to issue equity under reasonable terms to fund capital
 23 requirements.

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

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

2 A. Yes. I am sponsoring Exhibit No.____ (MTT-2) pages 1 through 6, which
3 were prepared under my direction. Avista’s credit ratings by S&P and Moody’s are
4 summarized on page 1. Avista’s actual capital structure at September 30, 2015, and
5 proposed capital structure, are included on page 2, with supporting information on pages 3
6 through 6. Confidential Exhibit No.____ (MTT-3C) is our Interest Rate Risk Management
7 Plan. Exhibit No.____ (MTT-4) includes the equity ratios and returns on equity approved
8 by various state regulatory commissions from January 1, 2015, through December 31, 2015.
9 Confidential Exhibit No.____ (MTT-5C) shows the Company’s planned capital
10 expenditures and long-term debt issuances by year.

11

12

II. FINANCIAL OVERVIEW

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

14 A. We are operating the business efficiently for our customers, ensuring that our
15 energy service is reliable and customers are satisfied while at the same time keeping costs as
16 low as reasonably possible. An efficient, well-run business is not only important to our
17 customers but also important to investors. We plan and execute on a capital financing plan
18 that provides a prudent capital structure and liquidity necessary for our operations. We
19 honor prior financial commitments and we continue to rely on external capital for sustained
20 utility operations. We initiate regulatory processes to seek timely recovery of our costs with
21 the goal of achieving earned returns close to those allowed by regulators in each of the states
22 we serve. These elements – cost management, capital and revenues that support operations

1 – are key determinants to the rating agencies whose credit ratings are critical measures of
2 our financial situation.

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

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

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

III. CAPITAL EXPENDITURES

Q. In the Commission’s Order 05 in Docket Nos. UE-150204 and UG-150205 the Commission required the Company in the future to provide more analysis showing how it plans and prioritizes capital investments.¹ Although the Commission’s directive was focused primarily on distribution plant investment, would you please explain how Avista plans and prioritizes all of its incremental capital investments?

A. Yes. We are continuing to make significant capital investments related to electric generation, transmission and distribution facilities, natural gas distribution plant, new customer connections, environmental and regulatory requirements, information technology, and other supporting functions such as fleet services and facilities. The objective in all of these investments is to enable the Company to continue to provide safe, reliable service to our customers, maintain a high level of customer satisfaction, and meet the current and future needs and expectations of our customers and other stakeholders, while at the same time being sensitive to the rate impacts to customers resulting from the investments.

In order to meet these objectives, there are a number of factors that must be balanced as we determine the appropriate level of investment each year including, but not limited to:

- 1) the level of investment needed to meet safety, service and reliability objectives and to further optimize our facilities;
- 2) the degree of overall rate pressure faced by our customers;
- 3) the variability of investments required for major projects;
- 4) unanticipated capital requirements, such as an unplanned outage on a large generating unit or significant storm affecting transmission and distribution facilities; and
- 5) the cost and availability of funding,

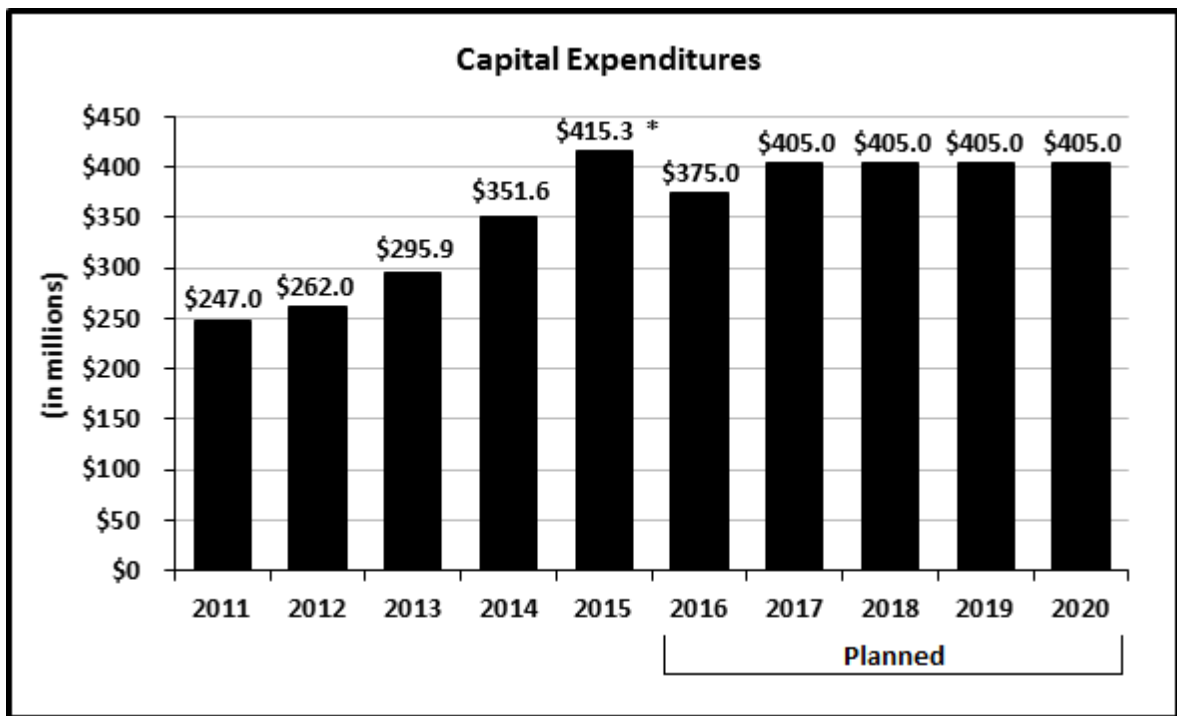
¹ Order 05, page 52.

1 which includes internally generated funds, terms for debt financing, and the opportunity to
 2 issue equity on reasonable terms.

3 **Q. What have been Avista’s recent capital expenditure levels, and what do**
 4 **you expect them to be for the next several years?**

5 A. Illustration No. 1 below summarizes the capital expenditure levels for recent
 6 years, as well as planned expenditures through 2020.

7 **Illustration No. 1**



16 ** The relatively higher level of capital expenditure in 2015 was driven by storm costs for*
 17 *the November windstorm, and costs related to a renegotiation of the Coyote Springs Long*
 18 *Term Service Agreement, which occurred late in the year.*

19 After the Company’s expected \$375 million capital investments in 2016, the capital
 20 expenditure level is expected to increase to \$405 million annually from 2017 through 2020.

21 **Q. Why has the Company increased the level of its capital expenditures?**

1 A. The increase in the level of capital investment in recent years is driven
2 primarily by the business need to fund a greater portion of the departmental requests for new
3 capital investments that, in the past, were unfunded.

4 While there are numerous factors driving the need for increased investment, they
5 generally fall into six broad categories. These categories are: (1) Asset Management, (2)
6 Compliance, (3) Improvements and Efficiencies, (4) Reliability Maintenance, (5) Resource
7 Supply, and (6) Safety and Security. There are overlaps and interdependencies among these
8 categories, and they are not necessarily all-encompassing.

9 A brief description of each of these categories is provided below. As other Avista
10 witnesses present and explain the specific capital projects and capital-related programs
11 included in this general rate case filing, they will provide additional details on the specific
12 purpose and objectives of the capital investments.

13 **Asset Management:** In many instances we have what we refer to as asset
14 management plans, which are designed to determine the efficient life cycle of the
15 assets. These asset management plans assess the useful life of the particular assets
16 and the appropriate time to replace the assets, balanced against the operations and
17 maintenance costs associated with maintaining assets that are toward the end of their
18 useful life. These asset management plans allow the Company to systematically
19 replace the assets over time in a manner that optimizes the value of the assets, while
20 still maintaining reliable service to customers. There are a number of programs
21 within electric distribution, substation, and transmission operations that require
22 programmatic annual proactive maintenance investment in order to maximize the
23 lifetime value of the associated assets. Specific asset management programs and
24 projects include wood pole management, Aldyl-A pipe replacement, transmission
25 line rebuilds, and substation equipment replacements and rebuilds.

26
27 **Compliance:** The compliance category is related to mandates from state and federal
28 governments and regulators, including, but not limited to FERC requirements;
29 NERC requirements; PHMSA requirements; requirements under franchise and right-
30 of-way agreements with WSDOT, cities, and counties; and environmental
31 regulations; among others. Additionally, this category includes the Company's
32 compliance with contractual agreements.
33

1 **Improvements and Efficiencies:** This category is related to keeping pace with
2 technological innovation, the identification of process improvements or efficiency
3 gains, and other opportunities to improve the Company’s operating assets. For
4 example, as technology has evolved, our customers have grown to expect new
5 functionality from our customer-facing technology assets (e.g., increased website
6 functionality, and mobile-friendly interaction).
7

8 **Reliability Maintenance:** This category represents the backbone of Avista’s ability
9 to meet its obligation to serve all customers with safe, reliable service. As discussed
10 by Company Witness Scott Morris, we believe the current reliability of our system is
11 satisfactory and is meeting the needs and expectations of our customers and other
12 stakeholders. However, in order to maintain this level of reliability, continued capital
13 investment is necessary, given that both new and existing assets deteriorate over time
14 and require replacement. Without responsibly working to maintain our plant in
15 service over time, we cannot continue to maintain our reliability levels.
16

17 **Resource Supply:** Avista’s ability to serve its customers is only as effective as its
18 ability to generate and procure energy resources. As discussed by Company Witness
19 Scott Kinney, Avista’s 2015 Electric Integrated Resource Plan shows forecasted
20 annual energy deficits and sustained annual capacity deficits beginning in the next 10
21 years. In light of this fact, it is critical that the Company continue to invest in
22 maintaining its current generating assets, along with planning to meet future resource
23 needs with both supply-side and demand-side resources.
24

25 **Safety and Security:** This category of investment includes security considerations
26 driven by threats to Avista’s operations, both cyber and physical. As cybersecurity
27 risks grow,² continued investment is required to respond to these risks. Additionally,
28 as evidenced by the Metcalf sniper attack on a PG&E substation, physical security
29 risks also exist, requiring investment to improve physical security. Aside from
30 security considerations, safety considerations are also important factors in
31 investment decisions and must be continually evaluated to ensure that customers, the
32 public at large, as well as Avista’s employees remain safe.
33

34 **Q. How do these categories ultimately translate into plant investment?**

35 A. As Mr. Morris briefly explained in his testimony, each year the departments
36 across the Company assess the near-term needs to maintain and upgrade the utility
37 infrastructure and technology necessary to continue to provide safe, reliable service to
38 customers, as well as maintain a high level of customer satisfaction. The departments

² As recently as December 2015, a substantial portion of Ukraine’s energy grid was blacked out by what is believed to be a hacking attack.

1 develop business cases for specific projects and programs that explain and support the need
2 for the capital investment. These business cases are submitted to a Capital Planning Group
3 that meets on a regular basis to review and prioritize all proposed utility capital investment
4 projects.

5 After taking into consideration a number of factors, senior management of Avista
6 establishes a proposed capital budget amount for each year of the next five years, which is
7 presented to the Finance Committee of the Board of Directors³. These factors include, but
8 are not limited to, the total capital investment requests of the departments submitted to the
9 Capital Planning Group, the urgency of the projects, the opportunities and risks associated
10 with delaying the projects to a later date, and the overall bill impact to customers associated
11 with the annual capital budgets ultimately approved. These five-year capital budget
12 amounts are revisited each year to ensure that capital dollars are dedicated to the highest
13 priority projects.

14 In recent years Avista has chosen to not fund all of the capital investment projects
15 proposed by the various departments in the Company, driven, in part, by the Company's
16 desire to mitigate the retail rate impacts to customers. The decision to delay funding certain
17 projects is made only in cases where the Company believes the amount of risk associated
18 with the delay is reasonable and prudent.

19 As a result of this constrained capital spend level, capital projects must be prioritized
20 so that the dollars flow where they are most needed. As unexpected, high-priority capital
21 projects arise, the capital projects for the year must be reprioritized to limit the total spend to
22 the amount established by the Company and approved by the Finance Committee of the

³ The Finance Committee is presented with a five-year plan, but approves the plan for only the next operating year.

1 Board. This can cause some projects to be delayed so that higher-priority projects can be
2 completed.⁴

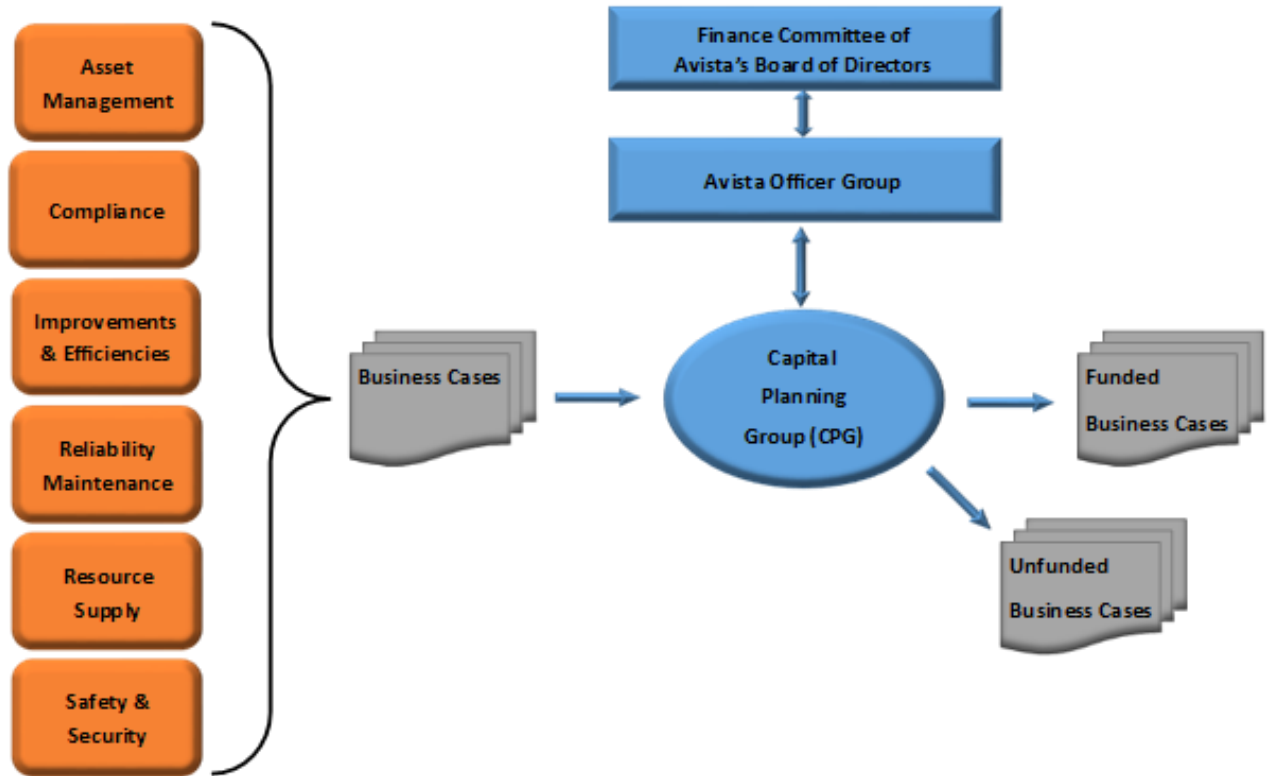
3 In addition, some scheduled capital projects will encounter unexpected delays due to
4 such things as permitting issues, delays in receipt of materials and equipment, etc. A delay
5 in one project may allow another project to be accelerated in time as part of managing the
6 availability of our workforce and to continue to make progress on projects next in the
7 “queue” that need to be done. This reprioritization occurs within the Capital Planning
8 Group, which is charged with ensuring that the total capital spend for the year stays within
9 the limit approved by the Finance Committee of the Board.⁵

10 The following illustration provides a graphical representation of how the Company
11 develops and prioritizes its capital investments.

⁴ The CPG is a group of Avista employee directors that represent all capital intensive areas of the Company. The CPG meets to review the submitted Business Cases and prioritize funding to limit the capital spend to the level set by senior management. After approval from senior management, the annual capital budget is sent to the Finance Committee of the Board of Directors to approve the capital budget amount. The CPG meets monthly to review the status of the capital projects and programs, and approves or declines new business cases as well as monitors the overall capital budget.

⁵ If circumstances indicate the capital spend for a year will exceed the level previously approved by the Finance Committee of the Board, the additional capital spend is presented to the Finance Committee for approval.

Illustration No. 2:



Q. How has the historical level of annual capital spending for Avista compared with the planned level?

A. The actual and planned capital spending for the utility for the years 2006 through 2015 are shown in Table No. 1 below. The table shows that actual capital spending has been very close to the planned spending on a consistent basis. The nine-year average of actual additions is 102% of the planned spending. This table also shows that while Avista has been increasing its capital spending it is generally remaining on budget.

Table No. 1:⁶

TABLE NO. 1			
Planned vs. Actual Expenditures			
	Planned Expenditures (\$ millions)	Actual Expenditures (\$ millions)	Percentage of Planned
2006	\$160.00	\$158.30	99%
2007	183.10	198.40	108%
2008	190.00	205.40	108%
2009	220.00	199.70	91%
2010	235.00	206.80	88%
2011	260.00	247.00	95%
2012	255.00	262.00	103%
2013	275.00	296.00	108%
2014	336.00	352.00	105%
2015	376.30	415.30	110%
Ten Year Average	\$249.04	\$254.09	102%

Q. In its Order 05, the Commission made reference to the extent to which the investments being made by the Company are “outside of its control, or required for the safe and efficient operation of its system.”⁷ What is the Company’s response?

A. As I explained earlier in my testimony, some of our incremental investments are out of our control from the perspective that they are, for example, directly related to compliance with mandates. In other instances, such as our asset management programs, one could argue that the annual investment is within Avista’s control, but it is also true that the Company has the obligation to responsibly manage the replacement of assets over time to maintain reliability and balance a number of competing factors such as the bill impacts to

⁶ The relatively higher level of capital expenditure in 2015 was driven by storm costs for the November windstorm, and costs related to a renegotiation of the Coyote Springs Long Term Service Agreement, which occurred late in the year.

⁷ Order 05, p. 47.

1 customers. Although we could choose to put off for tomorrow what does not absolutely
2 need to be done today, it would be imprudent to allow the system to deteriorate and begin to
3 jeopardize reliability, as well as potentially create a “bow-wave” of investment that needs to
4 be made in a relatively short period of time.

5 As indicated earlier, the objectives in our investments is to enable the Company to
6 continue to provide safe, reliable service to our customers, maintain a high level of customer
7 satisfaction, and meet the current and future needs and expectations of our customers and
8 other stakeholders, while at the same time being sensitive to the rate impacts to customers
9 resulting from the investments.

10 In this filing, the Company has provided detailed information, explanation and
11 supporting documentation to support the level of new capital investment proposed to be
12 included in retail rates for the January 2017 through June 2018 rate plan.

13 **Q. Please identify the witnesses providing this detailed information.**

14 A. The following witnesses provide detailed information, explanation and
15 supporting documentation related to new capital investment for the 18-month rate plan. In
16 addition, each witness, discusses the specific departmental prioritization plans and processes
17 used to establish the projects requested for funding in a particular year, which are then
18 reviewed and prioritized by the CPG within the overall capital spending plan.

19 **Scott Kinney’s** testimony addresses the drivers of the Company’s generation
20 investment, totaling \$246.7 million from 2016 through June 2018, mainly
21 related to the Company’s 100 year old hydroelectric facilities along the
22 Spokane River (i.e., Nine Mile, Post Falls and Little Falls generating
23 facilities), as well as our larger Clark Fork River hydroelectric facility at
24 Cabinet Gorge. Additional capital investments, such as those related to our
25 Colstrip thermal generating facility and other projects are also discussed.

26
27 **Bryan Cox’s** testimony addresses the Company’s need to invest in its electric
28 transmission plant, totaling \$125.3 million from 2016 through June 2018, to

1 maintain reliable customer service and meet mandatory reliability standards
2 (e.g., by the North American Electric Reliability Corporation (NERC)),
3 including projects such as the Noxon Switchyard Rebuild project, as well as
4 many other transmission, substation, and environmental projects to meet
5 reliability improvements, compliance and replacement, as well as contractual
6 agreements.

7
8 **Heather Rosentrater's** testimony addresses the Company's investment in
9 electric distribution plant, totaling \$184.5 million from 2016 through June
10 2018, explaining that the Company's investment is primarily driven by a
11 combination of the following factors: (1) new customer connections and
12 changing customer usage, (2) maintaining system reliability and safety, (3)
13 realizing operational and electrical efficiencies (including compliance with
14 the requirements of Washington Initiative measure No. 937), and (4)
15 minimizing life cycle costs of assets. Ms. Rosentrater also discusses Avista's
16 Asset Management approach, which strives to prioritize and plan work that
17 results in maximizing the value of Avista's physical assets by integrating
18 information about repairing, maintaining, inspecting, monitoring, and
19 replacing those physical assets through a comprehensive analysis. Examples
20 of Avista's Asset Management programs (and related capital investment
21 projects) include its Wood Pole Management, grid modernization,
22 transformer change-out, and improving worst feeders, to name a few.
23 Examples of additional capital projects discussed by Ms. Rosentrater, include
24 the Company's planned investment in Advanced Metering Infrastructure
25 (AMI), reconductor and feeder tie programs, new distribution substation
26 projects, storm damage repair, and street light management, to name a few.

27
28 **Karen Schuh's** testimony addresses the Company's investment in natural
29 gas storage, natural gas distribution plant, information systems and
30 information technology plant, and general plant, totaling \$313.9 million from
31 2016 through June 2018. Ms. Schuh discusses in further detail the capital
32 planning and review process, including the oversight provided by the Capital
33 Planning Group. Specific projects discussed by Ms. Schuh include general
34 plant related projects such as the Central Office Long Term Campus
35 restructuring plan, enterprise technology projects, such as the Next
36 Generation Radio Refresh program, Enterprise Security, High Voltage
37 Protection Upgrade projects, and natural gas distribution projects, such as the
38 Aldyl A Pipe Replacement and Natural Gas Isolated Steel Replacement
39 Programs, to name a few.

40
41 In the supporting documentation provided by Avista in this general rate case filing,
42 the Company has attempted to strike a reasonable balance of supplying robust supporting
43 explanation and documentation for its planned capital investments, while at the same time

1 not placing an undue burden on the record through the submittal of voluminous
2 documentation.

3 To the extent any party to the case requires additional information or documentation
4 associated with any of the Company's planned capital projects or programs, Avista is
5 prepared to provide additional information through responses to discovery, by conference
6 call, through site visits by the parties and other means. Avista's practice has been to be
7 transparent and responsive to requests for information in these, as well as other, regulatory
8 proceedings, and the same is true for these dockets.

9

10

IV. MATURING DEBT

11

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

13

A. In the next five years the Company is obligated to repay maturing long-term
14 debt totaling \$504.5 million. The table in Illustration No. 3 below shows the Company's
15 maturing long-term debt from 2016 through 2020. Within this five-year period, a large
16 concentration – \$272.5 million – matures within the second quarter of 2018.

Illustration No. 3

Avista Corp Long-Term Debt Maturities, 2016-2020				
Maturity Year	Principal Amount	Coupon Rate	Date Issued	Maturity Date
2016	\$90,000,000	0.84%	8/14/2013	8/14/2016
2017	-	-	-	-
2018	\$7,000,000	7.39%	5/11/1993	5/11/2018
	\$250,000,000	5.95%	4/3/2008	6/1/2018
	\$15,500,000	7.45%	6/9/1993	6/11/2018
2019	\$90,000,000	5.45%	11/18/2004	12/1/2019
2020	\$52,000,000	3.89%	12/20/2010	12/20/2020
Total	\$504,500,000			

These debt obligations originated as early as 1993 and their original terms were three, ten, fifteen and twenty-five years. These maturing obligations represent over a third (36%) of the Company's long-term debt outstanding at the end of 2015, which is a significant portion of our capital structure. The Company typically replaces maturing long-term debt with new issuances of debt. It will be necessary for Avista to be in a favorable financial position to complete the expected debt refunding, while also obtaining debt and equity to fund capital expenditures each year.

Q. What are the Company's expected long-term debt issuances in the next several years?

A. To provide adequate funding for the significant capital expenditures noted in Section IV above and to repay maturing long-term debt, we are forecasting the issuance of long-term debt every year for the next several years, as shown in confidential Exhibit No. (MTT-5C).

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

1 A. Yes. In addition to long-term debt, the Company's \$400 million revolving
2 credit facility expires in April 2019. The Company relies on this credit facility to provide,
3 among other things, funding to cover month-to-month variations in cash flows, interim
4 funding for capital expenditures, and credit support in the form of cash and letters of credit
5 that are required for energy resources commitments and other contractual obligations. Our
6 credit facility was amended in April 2014, which stretched the expiration date to April 2019,
7 five years past the amendment date, and reduced interest rates and fees. We expect to
8 initiate the renewal or replacement of the credit facility before the existing arrangement
9 expires. Any outstanding balances borrowed under the revolving credit facility become due
10 and payable when the facility expires. Again, a strong financial position will be necessary to
11 gain access to a new or renewed revolving credit facility prior to expiration of the existing
12 facility.

13

14

V. CAPITAL STRUCTURE

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

17 A. Our requested capital structure is 51.5 percent total debt and 48.5 percent
18 equity with a requested overall rate of return in this proceeding of 7.64 percent, as shown in
19 Illustration No. 4 below. The requested capital structure is an estimated capital structure
20 during 2017.

Illustration No. 4

AVISTA CORPORATION				
Proposed Cost of Capital				
	<u>Amount</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Component Cost</u>
Total Debt	\$ 1,653,000,000	51.50%	5.51%	2.84%
Common Equity	<u>1,556,708,738</u>	<u>48.50%</u>	<u>9.90%</u>	<u>4.80%</u>
Total	<u>\$ 3,209,708,738</u>	<u>100%</u>		<u>7.64%</u>

Q. Is the capital structure reflected in Illustration No. 4 above calculated in a manner similar to the capital structure calculated in Avista's recent rate proceedings?

A. Yes. This methodology considers debt and equity outstanding for Avista Corp. We have included a short-term debt balance of \$100 million, which represents approximately 3.12 percent of our overall capital structure.

Debt and equity for AERC, which was acquired in mid-2014, are excluded from this calculation and do not impact the capital structure calculation for this rate proceeding.

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

A. As a regulated utility, Avista has an obligation to provide safe and reliable service to customers while balancing fiscal safety and economy, in both the short term and long term. Through our planning process we determine the amount of new financing needed to support our capital expenditure programs while maintaining an optimal capital structure that balances and supports our current credit ratings and provides flexibility for anticipated future capital requirements.

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

2 A. On September 30, 2015, Avista's common equity percentage for the
3 Washington jurisdiction was 49%. The Company continues to evaluate the extent and
4 timing of equity issuances for 2016, taking into account our capital expenditures and other
5 financial requirements. These steps to manage our equity level are expected to result in an
6 average common equity level of approximately 48.5% for 2017.

7 Maintaining a 48.5 percent common equity ratio has several benefits for customers.
8 We are dependent on raising funds in capital markets throughout all business cycles. These
9 cycles include times of contraction and expansion. A solid financial profile will assist us in
10 accessing debt capital markets on reasonable terms in both favorable financial markets and
11 when there are disruptions in the financial markets.

12 Additionally, a 48.5 percent common equity ratio solidifies our current credit ratings
13 and moves us closer to our long-term goal of having a corporate credit rating of BBB+. A
14 rating of BBB+ would be consistent with the natural gas and electric industry average,
15 which I will further explain later in my testimony. We rely on credit ratings in order to
16 access capital markets on reasonable terms. Moving further away from non-investment
17 grade (BB+) provides more stability for the Company, which is also beneficial for
18 customers. We believe our requested 48.5 percent equity appropriately balances safety and
19 economy for customers.

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

22 A. Yes, it is absolutely essential. As a publicly traded company we have two
23 primary sources of external capital: debt and equity investors. As of September 30, 2015,

1 we had approximately \$2.9 billion of debt and equity. Approximately half of our capital
2 structure is funded by debt holders and the other half is funded by equity investors and
3 retained earnings. Rating agencies and potential debt investors tend to place significant
4 emphasis on maintaining strong financial metrics and credit ratings that support access to
5 debt capital markets under reasonable terms. Leverage – or the extent that a company uses
6 debt in lieu of equity in its capital structure – is a key credit metric and, therefore, access to
7 equity capital markets is critically important to long-term debt investors. This emphasis on
8 financial metrics and credit ratings is shared by equity investors who also focus on cash
9 flows, capital structure and liquidity, much like debt investors.

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

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

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

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

1 A. We are requesting a capital structure that provides us the opportunity to have
2 financial metrics that offer a risk/reward proposition that is competitive and attractive for
3 equity holders. We target a dividend payout ratio that is comparable with other utilities in
4 the industry. This is an essential element, along with potential growth, in providing a
5 competitive risk/reward opportunity for equity investors.

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

11

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VI. PROPOSED RATE OF RETURN

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**Q. Has Avista prepared an exhibit that includes the components of Avista's
requested rate of return of 7.64 percent?**

15

16

A. Yes. Exhibit No.____(MTT-2) shows the components of Avista's requested
rate of return of 7.64 percent.

17

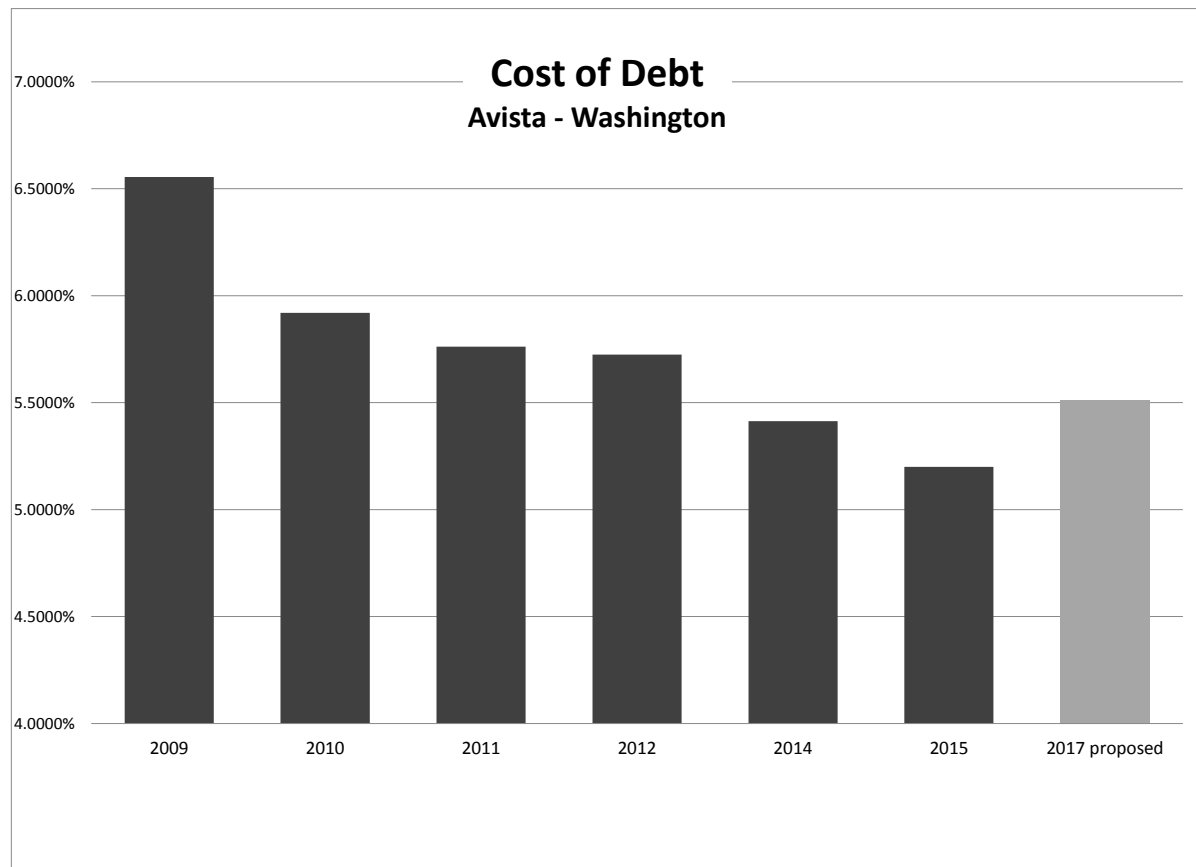
18

**Q. What is the Company's overall cost of debt, and how does the
Company's current overall cost of debt compare to its historic cost?**

19

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A. Our requested overall cost of debt is 5.51 percent. The cost of debt has
trended downward for Avista in recent years, as shown in Illustration No. 5 below.

Illustration No. 5

Q. Please explain why Avista's cost of long-term debt has decreased.

A. There has been a general decline in interest rates for several years while Avista has issued new debt, causing the Company's overall cost of debt to decrease. There is an increase in the proposed cost of debt for 2017, as compared to 2015, due to the maturation of \$90 million of debt with a coupon of 0.84 percent and an effective yield of -0.04 percent during 2016. In August 2013 we issued \$90 million of debt with a 3-year term. Avista executed interest rate hedges for \$85 million related to this debt, and at the time the debt was issued received a benefit of \$2.9 million related to the hedges. This benefit is amortized over the life of the debt, which results in an effective yield of -0.04 percent. We

1 do not expect our 2016 debt issuance to be the same or less than the effective yield on the
2 maturing 2016 debt and, therefore, the average cost of debt will increase in 2016.

3 We have been prudently managing our interest rate risk in anticipation of debt
4 issuances, which has involved fixed rate long-term debt with varying maturities, and
5 executing on our interest rate risk mitigation program for our forecasted debt issuances.

6 From 2011 through 2015 we issued \$415 million in long-term debt. The weighted
7 average interest rate of these issuances is 3.55 percent. These issuances have varying
8 maturities ranging from 3 years to 35 years, and a weighted average maturity of 23.6 years.

9 Our most recent issuance (in 2015) was \$100 million of first mortgage bonds with a
10 thirty year maturity at a rate of 4.37%. This new debt has an effective cost of 5.01% after
11 taking into account issuance costs and the settlement of interest rate hedges.

12 The prior year (in 2014) we issued \$60 million of first mortgage bonds with a thirty
13 year maturity at a rate of 4.11%. This debt, which matures in 2044, was the lowest priced
14 debt with a term beyond twenty years that the Company has issued since the 1950s. The
15 effective cost of this debt is even lower at 3.65%, which includes cost of issuance and the
16 impact of interest rate hedges. The \$5.4 million positive value of the interest rate hedges
17 (hedges were settled when the coupon rate was set) improved the effective yield on this debt
18 by 0.52%. I will discuss the interest rate hedging program later in my testimony.

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

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 We plan to continue issuing long-term debt with various maturities for the
5 foreseeable future in order to fund our capital expenditure program and long-term debt
6 maturities.

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

9 A. As mentioned earlier, we are forecasting \$1.2 billion in capital expenditures
10 over the next three years. Additionally, we have \$362.5 million of debt maturing during the
11 same period. This results in a significant need for the issuance of long-term debt to fund
12 these capital expenditures and maturing debt while maintaining an appropriate capital
13 structure.

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

20 We also manage interest rate risk exposure by limiting the extent of outstanding debt
21 that is subject to variable interest rates rather than fixed rates. In addition, we issue fixed
22 rate long-term debt with varying maturities to manage the amount of debt that is required to

1 be refinanced in any period (looking ahead to its future maturity), and to obtain rates across
2 a broader spectrum of prevailing terms which tend to be priced at different interest rates.

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

5 A. Yes. The Company's Interest Rate Risk Management Plan, attached as
6 Confidential Exhibit No.____(MTT-3C), is designed to reduce uncertainty of the effective
7 interest cost of future debt issuances. The plan provides guidelines for hedging a portion of
8 interest rate risk with financial derivative instruments. We settle these hedge transactions
9 for cash simultaneously when a related new fixed-rate debt issuance is priced in the market.
10 The settlement proceeds (which may be positive or negative) are amortized over the life of
11 the new debt issuance.

12 The interest rate risk management plan provides that hedge transactions are executed
13 solely to reduce interest rate uncertainty on future debt that is included in the Company's
14 five-year forecast. The hedge transactions do not involve speculation about the movement
15 of future interest rates.

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

18 A. Yes, the calculated cost of short-term debt includes credit facility availability
19 fees, interest on amounts borrowed, amortization of upfront costs, and forecasted LIBOR
20 rates. The result is a short-term debt cost of 2.66 percent, as shown in Exhibit
21 No.____(MTT-2) page 4.

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

1 A. We have a five-year credit facility in the amount of \$400 million with a
2 maturity date of April 2019. The credit facility involves participation by ten banks. This
3 credit facility was originally established in 2011 and it was amended in April 2014. Our
4 credit facility provides the ability to take out or repay short-term debt based on day-to-day
5 liquidity needs and to have letters of credit issued on the Company's behalf. The Company
6 pays fees under three price elements in the agreement: 1) a facility fee to maintain the right
7 to draw on the credit facility at any time, 2) interest on amounts borrowed, and 3) fees for
8 letters of credit.

9 The Company may request letters of credit (LCs) underwritten by the participating
10 banks and established for the benefit of counterparties to Avista. LCs are often used as
11 collateral when required for energy resources forward commitments, forward swap
12 transactions to hedge interest rate risk on future long-term debt, and other contractual or
13 legal requirements that involve the Company. The maximum available for LCs is \$200
14 million. The amount available for cash borrowing out of the overall \$400 million credit
15 facility is reduced by the amount of LCs outstanding.

16 Illustration No. 6 below summarizes the rates paid to maintain and use the credit
17 facility.

1 **Illustration No. 6**

2

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%

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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.

11 The Pricing Level and associated rates that we are charged is based upon our

12 underlying credit ratings as well as the security supporting the borrowings. Our current rates

13 are based upon Pricing Level II, which became effective in February 2014 based on the

14 Company's improved credit ratings. We achieve this Pricing Level by securing the credit

15 facility with First Mortgage Bonds. If we did not secure this credit facility with First

16 Mortgage Bonds, the costs would be based on Pricing Level IV, which would increase costs

17 to customers. There are also upfront costs paid for setting up the credit facility (i.e. legal

18 arrangement, bank commitments) that are amortized over the term of the credit facility.

19 **Q. The Company is requesting a 9.9% return on equity. Please explain why**

20 **the Company believes this is reasonable.**

21 A. We agree with the analyses presented by Mr. McKenzie which demonstrate

22 that the proposed 9.9 percent ROE⁸, together with the proposed equity layer of 48.5%,

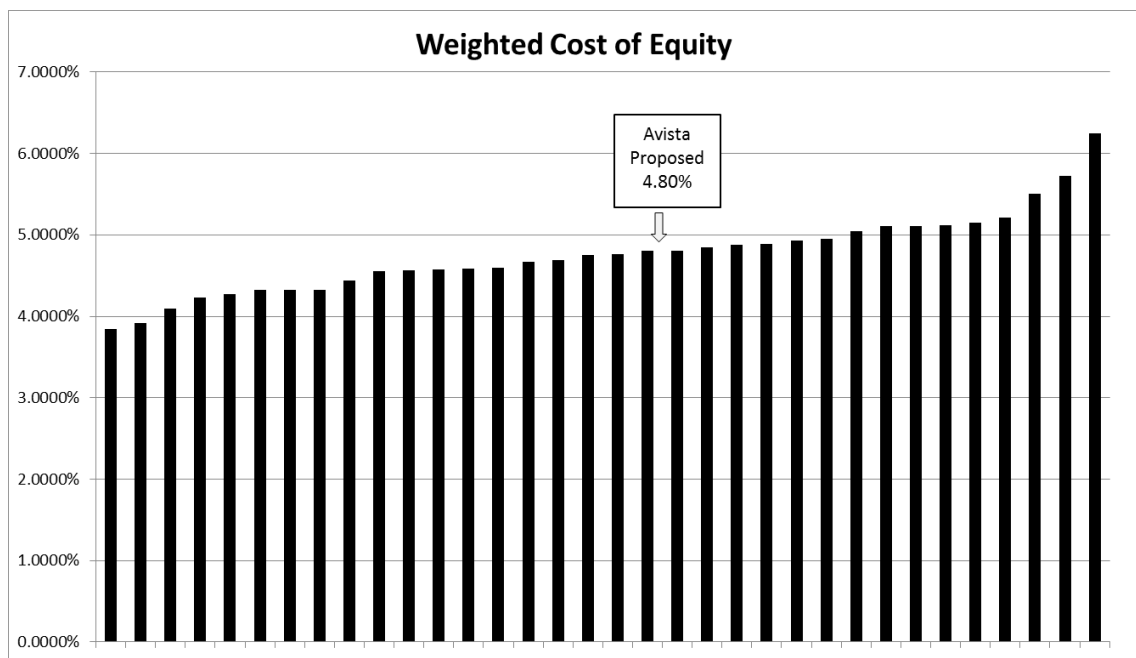
⁸ As stated by Mr. McKenzie, a 9.9 percent ROE is a conservative estimate of investors' required ROE for Avista.

1 would properly balance safety and economy for customers, provide Avista with an
 2 opportunity to earn a fair and reasonable return, and provide access to capital markets under
 3 reasonable terms and on a sustainable basis. The proposed weighted cost of equity is 4.80%
 4 (9.9% times 48.5%).

5 **Q. How does Avista’s requested 4.80 percent weighted cost of equity**
 6 **compare with the weighted cost of equity recently approved for electric and natural**
 7 **gas utilities in other jurisdictions?**

8 A. The bar chart in Illustration No. 7 below shows the weighted cost of equity
 9 approved by state regulators for investor-owned utilities across the country, for the twelve-
 10 month period from January 1, 2015 through December 31, 2015. These data in the bar chart
 11 represent all of the commission decisions that specify an ROE and equity ratio for utilities in
 12 this twelve-month period.

13 **Illustration No. 7⁹**



⁹ Source – SNL Financial, Rate Cases finalized January 1, 2015 through December 31, 2015.

1 Avista's proposed weighted cost of equity of 4.80 percent, which is also shown in
2 the chart above, is in the middle of the range of these weighted cost of equity numbers.
3 Additional details related to this chart, including the names of the utilities, are provided in
4 Exhibit No. ____ (MTT-4).

5 Because Avista competes with other utilities for equity investor dollars, it is essential
6 for Avista to be able to provide an earnings opportunity that is competitive with other
7 utilities.

8

9

VII. CREDIT RATINGS

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

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

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

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

	S&P	Moody's
Senior Secured Debt	A-	A2
Corporate Credit Rating	BBB	Baa1
Outlook	Stable	Stable

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6
7 Additional information on our credit ratings has been provided on page 1 of Exhibit
8 No. ____ (MTT-2).

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

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

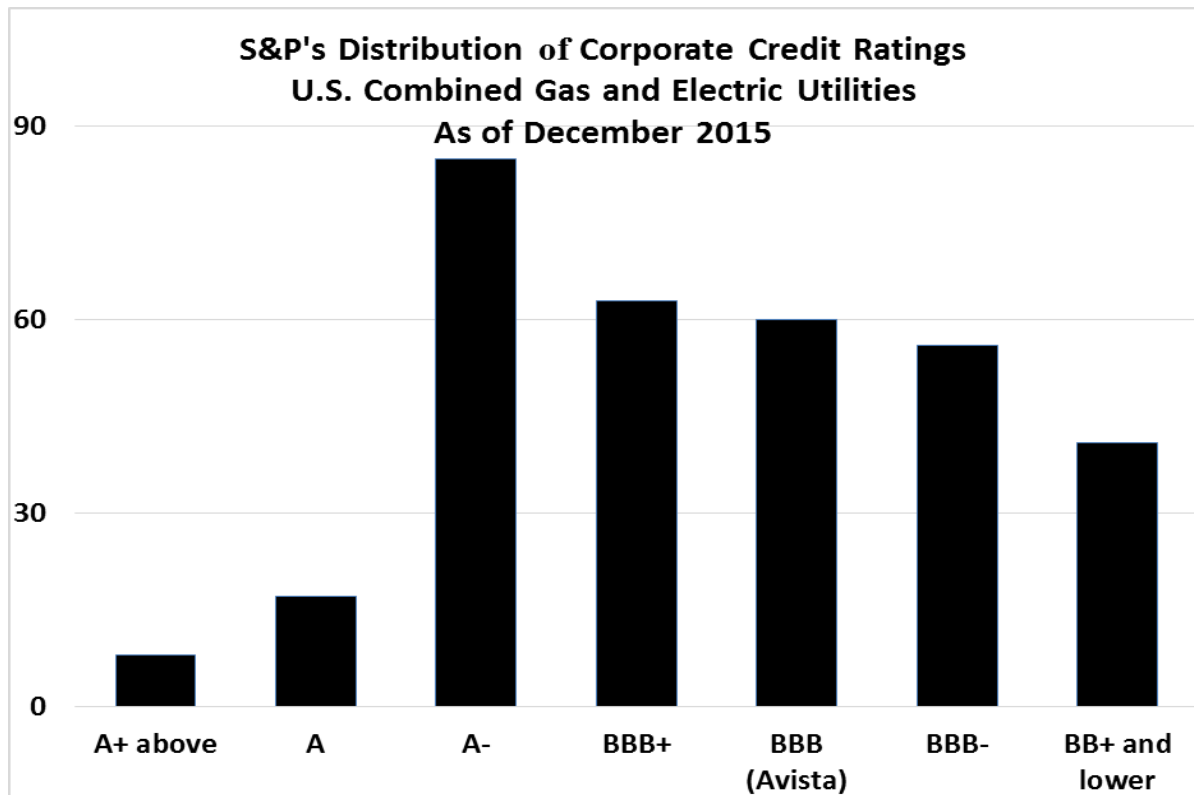
21 In challenging credit markets, where investors are less likely to buy corporate bonds
22 (as opposed to U.S. Government bonds), a stronger credit rating will attract more investors,
23 and a weaker credit rating could reduce or eliminate the number of potential investors.

1 Thus, weaker credit ratings may result in a company having more difficulty accessing
 2 capital markets and/or incurring significantly higher costs when accessing capital.

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

4 A. Avista’s current S&P corporate credit rating is BBB. We believe operating at
 5 a corporate credit rating level (senior unsecured) of BBB+ is comparable with other US
 6 utilities providing both electricity and natural gas. As shown in Illustration No. 8, the
 7 average credit rating for U.S. Regulated Combined Gas and Electric Utilities is BBB+ and
 8 the most common rating is A-. The average and most common ratings are one and two
 9 notches higher, respectively, than Avista’s rating.

10 **Illustration No. 8**



22 We expect that a continued focus on the regulated utility, conservative financing
 23 strategies and a supportive regulatory environment will contribute toward an upgrade to a

1 BBB+ corporate credit rating for Avista. Operating with a BBB+ credit rating would likely
2 attract additional investors, lower our debt pricing for future financings, and make us more
3 competitive with other utilities. In addition, financially healthy utilities are better able to
4 invest in the required infrastructure over time to serve their customers, and to withstand the
5 challenges facing the industry and disruptions in the financial market.

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

8 A. Both Moody's and S&P cite the regulatory environment in which a regulated
9 utility operates as the dominant qualitative factor to determine a company's
10 creditworthiness. Moody's rating methodology is based on four primary factors. Two of
11 those factors – a utility's "regulatory framework" and its "ability to recover costs and earn
12 returns" – make up 50 percent of Moody's rating methodology¹⁰.

13 S&P states the following¹¹:

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

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

¹⁰Moody's Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, December 23, 2013.

¹¹Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.

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

2 A. Yes.