BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NOS. UE-06______

DIRECT TESTIMONY OF

JULIE M. CANNELL

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

Q. Please state your name, employer, and business address.

A. My name is Julie M. Cannell. I am the president of my own advisory firm, J.M. Cannell, Inc. My business address is P.O. Box 199, Purchase, NY 10577.

Q. Please describe your professional and educational background.

A. My firm, J.M. Cannell, Inc., provides advisory services to electric utility companies and other firms and organizations with an interest in the industry. Prior to establishing my firm in February 1997, I was employed by the New York-based investment manager, Lord Abbett & Company, from June 1978 to January 31, 1997. During my tenure with Lord Abbett, I was a securities analyst specializing in the electric utility and telecommunications services industries; portfolio manager of America's Utility Fund, an equity utility mutual fund; portfolio manager of numerous institutional equity portfolios; and co-director of Lord Abbett's Equity Research Department. Further information on my background can be found in Exhibit No. ______(JMC-2).

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

A. I have been asked by the Company to discuss the perspective of investors with respect to the continuing need for the Energy Recovery Mechanism (ERM), and the proposed elimination of the $9 million deadband.

Q. What conclusion do you draw regarding the ERM and the need to eliminate the deadband?

A. Investors view the Energy Recovery Mechanism as a necessary and essential mechanism for cost-recovery for the Company. However, the fact that the mechanism contains a $9 million deadband subjects the Company to a fluctuation in earnings that is caused primarily by costs over which it has little control. In short, the existence of the deadband means that the predictability of Avista's earnings and cash flow is and will remain volatile. Investors believe that continuation of the deadband will prolong the timeframe for the Company to regain an investment grade credit rating. Moreover, the uncertainty associated with the volatility makes Avista a riskier investment, and investors can make other choices to invest their dollars, both within and outside of the utility sector where the risks are less. In the final analysis, it is what the investors believe that will influence their decisions.

Q. Please summarize what in your experience allows you to provide testimony about the viewpoint of investors.

A. As a securities analyst, I specialized in the electric utility industry and the individual companies comprising it. And as a portfolio manager, I applied that knowledge, along with investment fundamentals, toward investment decisions on behalf of institutions and individual investors. Moreover, I have reviewed the various reports of analysts and rating agencies, which have addressed the Company and the operation of its ERM.

Q. Please describe how your testimony is organized.

A. There are three parts to my testimony.

Investors' Perceptions Related to the Present Proceeding -- This section reviews the investment community's perceptions of Avista and Washington regulation, with specific emphasis on how investors view the ERM and the deadband. This review is based on a number of recent publications by rating agencies and investment analysts discussing their perceptions of the issue.

<u>How Investors Evaluate Investments in Utility Companies</u> -- This section discusses why investors choose to invest in electric utilities, with particular emphasis on why the regulatory climate in which the utility operates is of such importance to investors. This section of the testimony also discusses why the risk of investing in the electric utility industry has risen substantially in recent years on an industry-wide basis and why markets today react so swiftly and strongly to unfavorable news about a company.

<u>Energy Recovery Mechanism and Removal of the Deadband</u> --This section discusses Avista's request for continuation of the ERM and removal of the deadband associated with it. My conclusion is that the Company's proposal is one that investors view as important and constructive. Maintaining the ERM and eliminating the deadband would help to reduce the significant exposure Avista now has to volatile commodity prices. This in turn would lead to a more predictable stream of earnings and cash flow, and would be viewed favorably by rating agencies and the investment community at a time when increased financial stability is very important to the Company.

II. INVESTORS' PERCEPTIONS OF THE ERM

Q. Why is it important to consider the opinions of the investment community?

A. This topic will be explored more extensively in the next segment of my testimony. Suffice it to say, however, investors provide the capital necessary to maintain and expand the Company's infrastructure, which in turn enables Avista to provide reliable service to its customers. Perceptions of the investment community matter. The availability and cost of necessary funding ultimately impacts Avista's customers.

Q. How have you gauged investors' perceptions of the issues in this proceeding?

A. To supplement my own knowledge of the industry, I have reviewed various reports related to Avista written by the credit rating agencies and investment analysts. A clear picture of investors' perceptions emerges from these reports, which is very much in keeping with my own views.

Q. What are the most recent views expressed by the rating agencies with respect to the ERM?

A. In its November 29, 2005 report Fitch stressed the importance of the ERM, but expressed concern over the Company's exposure to commodity price volatility associated with the deadband:

"The primary concern for AVA fixed income investors is that poor hydro conditions, which have been below normal in five of the past six years, and high natural gas prices will continue to result in commodity costs that exceed the amounts recovered in rates, negatively impacting utility cash flow and liquidity. <u>While regulatory mechanisms are in place to recover the majority of such prudently incurred costs, the proportion absorbed by the company together with regulatory lag in the recovery of large deferred energy cost balances will hinder AVA's financial performance</u>.

Recent Developments: In August 2005, AVA reached a non-unanimous settlement agreement in its pending Washington electric and natural gas general rate cases. The settlement, which does not bind the Washington Utilities and Transportation Commission (WUTC), would resolve all issues related to the pending general rate cases, if adopted by the commission. While the proposed electric and natural gas rate increases included in the settlement are meaningfully lower than the amounts requested by AVA in its May 2005 filings (a combined rate increase of approximately $23 million versus a requested $39 million), <u>the dead band reduction to $3 million from $9 million could significantly reduce the utility's exposure to commodity price volatility</u>. The settlement also includes an equity build feature that proposes utility only equity ratios as a portion of total capital of 35% and 38% by December 31, 2007 and 2008, respectively. Fitch believes adoption of the proposed settlement agreement would be a constructive development for AVA fixed income investors."

--November 29, 2005 report: *Avista Corporation* (emphasis added)

In the same publication, the rating agency also cited "Regulatory lag in the recovery of deferred energy costs" as one of its "Key Credit Concerns." For its part, Standard & Poors, in its February 4, 2004 report on Avista, similarly noted that, "Avista's financial profile is slightly weak for the rating, reflecting the significant amount of debt that remains outstanding from the power crisis as well as the delay in the recovery of the deferred power costs due to below-average hydro conditions."

Q. What conclusion do you draw from the credit rating agencies' comments about Avista?

A. I believe the agencies view the Energy Recovery Mechanism as a positive factor in permitting recovery of a portion of the variability of power costs, particularly in light of Avista's significant reliance on hydroelectric and gas-fired generation, both of which are characterized by volatility. Fitch Investors specifically noted that reduction of the ERM deadband from $9 million to $3 million, as proposed in the rate case settlement reached in August 2005, would markedly reduce Avista's exposure to commodity price volatility. Both Fitch and Standard & Poors expressed concern about the delay in the recovery of deferred power costs. In light of the credit rating agencies' collective comments, I believe that any move by the WUTC to discontinue the ERM could have serious ramifications for the Company's credit quality. The elimination of the deadband would, conversely, be a positive credit factor, as the impact of commodity price volatility on the Company would thereby be mitigated.

Q. Please turn your attention now to equity investors. Have any institutional investors commented on Avista and its ability to recover costs?

A. Yes. KeyBanc Capital Markets recently discussed the risk associated with Company's need to purchase power and the ERM:

"AVA's generation mix is skewed toward hydroelectric generation (980MW of 1806 total owned MW), which is extremely dependent upon winter snowpack, seasonal precipitation and ultimately spring run-off conditions in various locations throughout the Pacific Northwest. When these conditions are above normal, which has been the case over the past several years, AVA is forced to purchase power through more expensive channels, leading to increased earnings volatility due to the lack of a one-for-one pass-through of these costs to customers. In our view, this regulatory construct puts asymmetric downside risk on the Company, as low hydro levels force AVA to buy (and partially absorb the cost of) power during periods of regional scarcity. Conversely, when hydro conditions are strong, AVA retains a portion of the benefit of pricing that will be weak, as the entire region is likely to be seeing a glut of cheap hydro resources."
--November 10, 2005 report: *Avista Corporation: Regulatory Settlement and Reduced Natural Gas Trading Should Allow for Improved Earnings; Coverage Initiated with a Buy (2) Rating*. (emphasis added)

KeyBanc even more recently addressed the Commission's December 2005 order in the Company's rate case, noting the level of earnings put at risk with the continuation of the deadband:

"RISKS: We believe the primary risk that could impede the stock from achieving our price target is a retreat in the relative valuation of utilities vs. the broad market. Additionally, while the WA commission approved most parts of the Company's settlement, the question of reducing the deadband (the amount of replacement energy costs the Company absorbs or retains before sharing with customers) remains open to further discussion. The settlement proposed reducing the deadband from $9 million to $3 million. With our 2006 estimate assuming this reduction, we see $0.08 per share of 2006 earnings at risk. We are, however, somewhat encouraged by language in the order approving the settlement."
--January 19, 2006 report: *Avista Corporation: AVA: Increasing Price Target to $20.50.*

Q. Have other institutional investors addressed the Company's ERM and deadband?

A. Yes. D.A. Davidson highlighted the impact on earnings resulting from the underrecovery of costs:

"We are assuming the WUTC will grant implementation of the settlement agreement as presented. Despite the expected rate increase, utility results in 2006 will still be held back by the portion of rising fuel and power costs that the company will need to absorb after reaching the new dead band level, imperfect recovery of all costs incurred and regulatory lag, as well as customer conservation due to price elasticity."

--October 28, 2005 report: *Avista Corporation*. (emphasis added)

Q. Has A.G. Edwards & Sons also opined on the ERM?

A. Yes. The firm discussed the ERM in connection with the WUTC's Dec. 21, 2005 approval of the Company's rate settlement, with conditions:

"The most important modification was the WUTC rejection of the proposal to reduce the Energy Recovery Mechanism (for electric fuel and purchased power costs above/below the level provided in base rates) dead band from the current $9 million annually to $3 million. Costs above/below the dead band are shared 90% with customers and 10% with company. In recent years, AVA has fully absorbed $9 million per year dead band because of below average hydroelectric conditions and high natural gas prices. This proposed modification is at least a temporary disappointment since the lower dead band was a, perhaps the, key positive in the settlement…. We are hopeful that the dead band will be reduced from $9 million but do not have a strong feel for this.

Rejection of the lower ERM dead band makes us less confident in our $1.60 2006 EPS estimate, $1.35 after removing earnings related to an expected gas storage accounting gain. Despite this, we are maintaining our estimate until we have a better feel for the likely outcome of the ERM review. If the dead band were to remain at $9 million, our 2006 EPS estimate would be reduced by $0.08 and our valuation estimate would fall by approximately $0.50."

--December 22, 2005 report: *Avista Corporation: State Regulators Approve Rate Settlement; But Reject Dead Band Reduction For Now*. (emphasis added)

Q. Has A.G. Edwards also commented on the Company's valuation, as it relates to the Company's ability to fully recover fuel and purchased power costs?

A. Yes, it has.

"**Valuation:**

We estimate the fair value of AVA shares at approximately $19. We value Avista Utilities at approximately $18 per share using 95% of the peer group multiple (15.4) or 14.6 times our $1.22 EPS estimate for 2006. The discount reflects below investment grade credit ratings and the inability to fully pass through fuel and purchased power costs to customers.

Risks to Valuation:

Key risks to our fair value estimate include uncertainty as to the outcome of the pending Washington rate case, the volatility of Energy Marketing earnings and Avista Utilities heavy dependence on purchased power and regulatory schemes that put the company at risk for a portion of its fuel and purchased power costs."

--July 28, 2005 report: *Avista Corporation: 2Q Earnings Better Than Expected Due Largely To Special Items*. (emphasis added)

Q. Please summarize your observations of the investors' comments about the Company and its ability to fully recover fuel and purchased power costs.

A. The commentary offered by these analysts indicates their acute awareness of the lack of resolution associated with the ERM and the material impact the mechanism can have on the Company's earnings power. KeyBanc quantified the impact that the proposed reduction in the deadband would have on earnings, as did A.G. Edwards. Further, as A. G. Edwards observed, one of the risks associated with its valuation of Avista's investment potential is "regulatory schemes that put the company at risk for a portion of its fuel and purchased power costs." In the final analysis, investors have a very large universe of stocks from which to select; with few exceptions, they have no requirement to own electric utility stocks. Because investors—as will be discussed in more detail below—now require a higher return for investing in the electric utility industry to balance the increased risk associated with it, individual electric companies with unpredictable earnings streams are less attractive.

III. HOW INVESTORS EVALUATE INVESTMENTS IN UTILITY COMPANIES

Q. Why do investors invest in electric utilities?

A. Historically, electric utility common stocks have been regarded as investment vehicles that provide stable performance through the ups and downs of market cycles and changing economic conditions. Electric utilities have typically earned a reasonable return even when conditions were not favorable for other companies. In addition, the reliability of electric utilities' earnings streams permitted most utilities to pay regular dividends consistently during both good and bad economic cycles. For investors needing regular cash income, the prospect of regular dividends has been a significant reason to invest in electric utility stocks.

Based on these factors, investors have traditionally viewed electric utility stocks as bond substitutes. In other words, electric utility stocks have provided regular cash returns in the form of dividends and the shares themselves were seen as having a stable underlying value. Electric utilities historically have paid out a large proportion of their earnings as dividends, and their large construction programs have kept them dependent on the capital markets. As a result, electric utility stocks as a group have tended to move closely in line with the direction of interest rates, but in an inverse relationship. That is, utility stock prices rose when interest rates fell, and vice versa. These factors made electric utilities a preferred investment during economic slowdowns or recessions. Owning them was a way of balancing the risks in a portfolio of stocks that included stocks in more volatile industries.

Q. Have the recent changes in the industry increased the risk of investing in electric utilities?

A. Yes. Investors now understand that the predictability of the electric utility industry's earnings, across the sector, has been undermined by the restructuring that has taken place in many parts of the country and by the volatility of commodity prices. These risks are in addition to the risks posed by technological, economic, environmental and other policy changes that affect the industry. These increased risks means that investors no longer perceive electric utilities as a group as being as much the "safe havens" they once were.

Investors' goals, however, have not fundamentally changed. They still look to electric utilities primarily as defensive investments, and still look for stable performance and regular dividends as the reason to invest in electric utilities. But investors also understand that the investment risk in electric stocks has risen significantly, and as a consequence, investors' goals in investing in this sector may have been frustrated.

In the end, investors have a very large universe of stocks from which to select; they have no requirement to own electric utility stocks. Consequently, investors now require a higher return for investing in the electric utility industry to balance the increased risk associated with it. They also look toward mechanisms such as the ERM to address the variability of fuel and purchased power costs.

Q. How do investors view Avista's earnings stream and, consequently, the attractiveness of its stock?

A. As noted in the preceding published comments from investors, the analysts are concerned about the volatility of the Company's earnings related to the ERM deadband. All other things being equal, the stability of a Company's earnings stream increases the attractiveness of an investment. Elimination of the deadband would significantly reduce the fluctuations in Avista's earnings stream. Because of the resulting earnings certainty and predictability, investors would likely consider the Company's stock a more desirable investment; moreover, this would assist the Company in returning to investment grade status on its debt.

Q. You referred earlier to the heightened uncertainty in the industry brought about by restructuring. But given Washington's more conservative approach to industry restructuring, why would these concerns affect Avista?

A. Markets tend to make judgments about investment risks that apply to industry sectors as a whole. Company specific risk factors are additive to sector risk. In other words, investors first determine the risk involved in investing in a particular industry. If they think such an investment to be prudent, they then consider the specific risks applicable to a particular company. Indeed, the Company was subject to significant uncertainty during the Western power crisis and its aftermath, and the valuation of its stock during that period reflected that heightened risk.

Q. In your experience as an analyst and portfolio manager, could a perceived change in a company's regulatory climate affect your investment opinion?

A. Absolutely. During my tenure as an active institutional investor, the quality of a company's regulatory environment was a critical factor in my assessment of its investment attractiveness. An adverse regulatory decision could be a key determinant in my recommendation or decision to sell a stock already owned or not make an investment in one under consideration.

Q. Why is the perception of regulatory climate of such importance to investors?

A. Equity investors today are still seeking companies that can offer stability in earnings and dividends. Fixed income investors look for stable and adequate cash flows to ensure payment of principal and interest when due, as indicated by stable credit ratings. The ability to pay dividends and meet debt service obligations is directly related to the consistency and sufficiency of a utility's earnings, which depend in large part on how the utility is regulated. If there is uncertainty about whether regulation will allow a utility the opportunity to earn a reasonable return in future years, and recover its costs, then that uncertainly will lead investors to avoid holding investment positions in the utility, all other things being equal.

Q. How has the investment industry itself changed in recent years?

A. In recent years, institutional investors and hedge funds have grown dramatically in the amount of capital they control. This growth has had a significant impact on the speed with which the market reacts to unfavorable developments. It has led the market to be much more reactive and much less forgiving than it may have been in the past.

Q. Why are institutional investors of such importance generally?

A. Because of the sheer size of their investment positions, institutions can effectively direct the course of individual securities, if not the market as a whole. Institutional investors include financial institutions such as mutual funds, investment companies, insurance companies, commercial and investment banks, and various types of public retirement funds. They approach the investment selection process from the standpoint of a portfolio. An investment portfolio is a collection of stocks selected to achieve the highest possible return commensurate with an acceptable level of risk. Therefore, institutional investors only keep electric utilities in their portfolios when such stocks contribute to achieving the desired risk/return relationship.

The individuals who make the decisions concerning these investments are paid money managers. Their performance is judged in large measure on how they react to developments in the market, including changes in the regulatory environment.

Q. Why are institutional investors important to Avista?

A. Institutions, because of the sheer size of their investment positions, can dramatically affect the market for Avista shares through their decisions to buy or sell. Because institutional investors own large blocks of shares relative to the volumes typically traded, their activity in a company's shares is often reflected in a significant change in the price and volume of shares traded. This change may be picked up by other institutional investors, by the investment community in general, and eventually by individual investors. These other entities will then look to see what is driving this trend in the stock and whether the trend is likely to continue or disappear. If they see support for the trend, they may follow the lead of the firms that initially began to move the market, and by following the leaders, the late movers may further strengthen the trend. It should be remembered that approximately 60% of the outstanding shares of Avista Corporation's common stock are owned by institutional investors.

Q. Why might an institutional investor choose not to hold investments in a company like Avista?

A. There may be several reasons. First, institutional investors have fiduciary responsibilities. For example, Federal ERISA laws mandate that a portfolio manager's decisions meet the so-called "prudent man" standard. In other words, portfolio managers are expected not to make investment decisions or to retain stocks that are unduly risky given the investment goals of the portfolio.

In addition, institutional investors have performance pressures. Relative performance is what counts. By relative performance, I mean that investment performance is gauged against a market proxy (such as the Standard & Poor's 500 Index) or a peer group of investors (i.e., investors with a similar style). Mutual fund rating organizations such as Morningstar track and publicize the relative performance of mutual funds, and various pension consultants perform the same service for their client organizations.

Q. What happens when an institutional investor underperforms?

A. The results can vary, but eventually, underperformance will result in lost business and personnel changes. Mutual fund shareholders can sell their fund shares. A pension plan sponsor can fire the professional investor or reduce the assets under their investor's management. And, of course, poor performance also disadvantages the individual, who has entrusted his monies to the institution for management.

Q. How long a period does an institutional investor have before performance becomes an issue?

A. Again, it can vary. However, institutional investors no longer have the luxury of a long time horizon in which to show performance. Investors want results. Given the public visibility of investment results (through organizations such as Morningstar and the various pension consultants) and the resulting performance pressure, most investment organizations are now operating with a much shorter time horizon than in years past. Generally speaking, a long investment time horizon today can be as short as 12-18 months. So, a stock that is unlikely to perform within the prescribed time horizon is usually not attractive for purchase or continued investment by an institutional investor.

Q. What does this mean for investments in regulated utilities specifically?

A. This shortened time frame means that if there is bad news, institutional investors are more likely to react quickly.

Q. Do all institutional investor function within the time frames you describe?

A. No. There is a type of institutional investor called a hedge fund that frequently buys and sells the same stock during the course of a day.

Q. What impact do hedge funds have on the market in general and stocks in particular?

A. Their impact can be even more dramatic. Hedge funds are well known for trading in information; their actions are frequently event-driven. Sometimes that information is factual and other times it falls into the category of rumor. Because investors at hedge funds have wide information networks and are in frequent communication with companies and a broad range of other investors, they have the ability and the power to create volatility, which in turn impacts the movement of stock prices. The number of hedge funds participating in the market and the funds' assets have grown exponentially in recent years—recent estimates put the numbers at over 8000 firms with assets of $1 trillion globally near the end of 2004, with the top 150 U.S. hedge funds' assets at almost $500 billion, compared to 610 firms with $39 billion in assets in 1990. Accordingly, they have become a very strong force both in the market and in stocks in which they are interested. When they like an industry group or a stock, hedge funds can provide substantial support to stock prices. Conversely, when they become disenchanted, their tendency is to sell quickly. Although their focus is not on contributing to orderly markets, hedge funds are a formidable presence in the market place and must be reckoned with.

Q. What role do rating agencies play in investors' expectations?

A. In the wake of financial disasters, bankruptcies, and the ensuing severe erosion in investor confidence in the past few years, creditworthiness has become critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, a spillover effect soon was seen on healthy utilities. Part of this was due to the fact that the rating agencies came under harsh criticism that they had failed to catch problems early enough in companies such as Enron Corp. As a result, they began to heighten their scrutiny of all entities under their watch and became far more proactive in making rating changes. As well, "headline risk" began to come into play, as investors worried that–when credit problems in an industry are in the headlines—any company in the sector could be vulnerable to a downgrade. Thus, equity investors now closely watch the actions of the credit agencies, because any change in ratings can have a significant impact on a company's stock price.

Q. What happens when a credit downgrade occurs?

A. In the simplest terms, it becomes more expensive for a company to raise money in the capital markets because a downgrade raises a company's risk profile and consequently, increases the cost of debt. Because of the increased linkage these days between ratings and stock prices, the common stock price is frequently affected—sometimes quite strongly—by a downgrade. To take an extreme example, Moody's Investors Service cut the ratings of Allegheny Energy and its subsidiaries to "junk," or below investment-grade, status on October 1, 2002. The prior day, September 30, Allegheny's stock price closed at $13.10. By October 8, when the company announced that it was in technical default with creditors due to its inability to meet higher collateral requirements prompted by the downgrade, the stock closed at $3.80. Thus, in the space of a week, Allegheny's stock price—and the value of a shareholder's investment—lost 71% of its value. Although this is an extreme example, it is nonetheless indicative of why the markets now watch changes in credit ratings so closely.

IV. ENERGY RECOVERY MECHANISM AND REMOVAL OF THE DEADBAND

Q. What would investors and credit rating agencies consider to be a positive outcome in this proceeding?

A. I believe the current view of Avista by the investment community reflects an expectation that the ERM will be continued, and the repeated reference to the $9 million deadband suggests that it is a major factor the investment community takes into consideration in assessing the risks associated with an investment in the Company.

Elimination of the deadband would increase the predictability and decrease the volatility of Avista's earnings, at a very important time when the Company is moving toward significant refinancing of debt and major capital expenditures. Accordingly, the risk level associated with an investment in the Company would decline, making capital less expensive to obtain. A return to an investment grade credit rating would also be greatly facilitated by maintaining the ERM and eliminating the deadband.

Q. Conversely, what would the likely reaction of investors and credit rating agencies be to WUTC action that withdraws the ERM or maintains the existing $9 million deadband?

A. I believe it would be highly unfavorable. As Fitch Ratings opined in its Nov. 29, 2005 report: "…the dead band reduction to $3 million from $9 million could significantly reduce the utility's exposure to commodity price volatility. … Fitch believes adoption of the proposed settlement agreement would be a constructive for AVA fixed income investors." Among equity investors, KeyBanc opined in its January 19, 2006 publication: "Additionally, while the WA commission approved most parts of the Company's settlement, the question of reducing the deadband…remains open to further discussion. …With our 2006 estimate assuming this reduction, we see \$0.08 per share of 2006 earnings at risk. We are, however, somewhat encouraged by language in the order approving the settlement."

Should the ERM itself be fully withdrawn, I believe the reaction of the investment community could be swift and harsh, as suddenly Avista would be left without any systematic way of recovering its volatile fuel and purchased power expense. Should the deadband be retained, I also think that investors' response would be negative. While the analysts understand that the ERM issue hasn't been resolved, I believe their comments relative to the proceeding reflect anticipation of continuation of the ERM, but with the need to address the negative effects of the deadband.

Q. Does that conclude your prefiled direct testimony?

A. Yes, it does.