BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-05_______

DOCKET NO. UG-05_______

DIRECT TESTIMONY OF

MALYN K. MALQUIST

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

4 A. My name is Malyn K. Malquist. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corp. (Company or Avista)
6 as Senior Vice President, Chief Financial Officer, and Treasurer.

7 **Q. Would you please describe your education and business experience?**

8 A. I received a Bachelors degree and a Master of Business Administration
9 degree from Brigham Young University. I have also attended a variety of utility finance
10 courses and leadership programs.

11 I joined Avista Corp. in September of 2002 as Senior Vice President. In
12 November 2002 I was named to the additional position of Chief Financial Officer. In
13 March 2004 the position of Treasurer was also added. Prior to joining Avista, I was
14 General Manager of Truckee Meadows Water Authority in Reno, Nevada, which was
15 separated out from Sierra Pacific Power Company in 2001. I was Chief Executive
16 Officer of Data Engines, Inc., a high tech company located in Reno from June to October
17 of 2000. From April 1994 to April 2000, I was employed by Sierra Pacific Resources, first
18 as the company's chief financial officer and later as its chairman of the board and chief
19 executive officer. Following the merger of Sierra Pacific Resources with Nevada Power
20 Company in 1999, I became the President of both Sierra Pacific Power Company and

1 Nevada Power Company. For the sixteen-year period up to 1994, I was employed by
2 San Diego Gas & Electric Company in various positions, including Treasurer and Vice
3 President – Finance.

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

5 A. I will provide a financial overview of the Company and will explain the
6 overall rate of return proposed by the Company in this filing for its electric and natural
7 gas operations. The proposed rate of return is derived from Avista Utilities' costs of
8 debt (short-term and long-term debt), trust preferred securities, preferred equity and
9 common equity, weighted in proportion to the proposed capital structure.

10 I will address the proposed capital structure, debt cost and preferred equity cost
11 components. Witness Avera will testify to the appropriate return on equity level for the
12 Company.

13 In brief, I will provide information that shows:

14 • We have been aggressively rebuilding our financial health by improving our cash
15 flow, managing our costs and paying down debt. Since 2001 the Company has
16 repurchased approximately $319 million of its higher-cost debt. Unfortunately,
17 drought conditions experienced by the Company, along with the recent volatility
18 of energy commodity costs, require us to purchase more expensive replacement
19 power and pay higher prices for natural gas to run our natural gas turbine
20 generation.
21
22 • Although the earnings impact of replacement power and higher fuel costs is
23 mitigated to some degree through electric and natural gas power cost deferral
24 and recovery mechanisms in each of Avista's jurisdictions, the large deferral
25 balances on the Company's books negatively impact the amount of available
26 cash flow from operations, may lead to additional borrowings, and ultimately

1 results in higher debt, lower interest coverage ratios and a weaker financial
2 condition for the Company.
3
4 • In addition, major capital expenditures are planned for 2005-2006 of
5 approximately $275 million for customer growth, necessary maintenance and
6 replacements of our natural gas utility systems, as well as investment in
7 generation, transmission and distribution facilities for the electric utility business.
8 Avista needs adequate cash flow from operations to fund these requirements.
9
10 • Avista's corporate rating is currently BB+, which is below investment grade.
11 Avista Utilities should operate at a level that will support a strong investment
12 grade credit rating, meaning at least a strong "BBB" or weak "A". The
13 Company's financial performance has improved since 2001, however, we are still
14 not realizing the coverages needed to regain an investment grade rating and the
15 Company does not expect to do so until at least 2006.
16
17 • The Company has proposed an overall rate of return of 9.67%, including a 44%
18 equity ratio and an 11.5% return on equity. In this case, although we believe an
19 ROE greater than 11.5% is supported and is warranted, we also believe the 11.5%
20 provides a reasonable balance of the competing objectives of regaining financial
21 health within a reasonable period of time, and the impacts that increased rates
22 have on our customers.
23
24 An improved credit rating to investment grade is only likely if the Company's
25 financial strength and its outlook improve for a sustained period of time. The
26 Company's initiatives to carefully manage its operating costs and capital expenditures
27 are an important part of improving performance, but are not sufficient without
28 revenues from the general rate request for electric and natural gas in this case.
29 Certainty of cash flows from operations can only be achieved with the continued
30 support of regulators in allowing the timely recovery of costs and the ability to earn a
31 fair return on investment.

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

2 A. Yes. I am sponsoring Exhibit No. ___(MKM-2), which was prepared

3 under my direction.

4 **II. FINANCIAL OVERVIEW**

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

6 A. Although the Company has made good progress in improving its financial

7 health in recent years, Avista's credit ratings remain below investment grade and are

8 anticipated to remain there until at least 2006. During the energy crisis of 2000 and

9 2001, it was necessary for the Company to issue a significant amount of debt to cover

10 electric and natural gas costs incurred by the Company, but not yet paid for by Avista's

11 customers. These costs were deferred, or set aside, for future recovery under the

12 accounting treatment approved by the Commission. These deferred electric and natural

13 gas costs reached over $340 million in 2001 on a system basis. The electric deferrals

14 were driven primarily by the combination of record-low hydroelectric conditions and

15 unprecedented high wholesale market prices that occurred in 2001. Wholesale natural

16 gas prices were also very high during the period.

17 During that time investors and lenders were reluctant to invest in the utility

18 industry, including Avista, and were demanding higher interest rates. Much of the debt

19 issued by Avista during this time was at rates exceeding 9%. As a result, Avista's

20 <u>annual</u> interest costs rose from approximately $69 million in 2000 to over $105 million in

1 2001 and 2002. In addition, Avista's debt ratio rose to over 59% by December 2001[1] and
2 the amount of debt outstanding rose from $715 million in January 2000 to $1,175 million
3 at December 31, 2001.

4 These events led to significant cash needs and a deterioration of the Company's
5 financial condition. In October 2001, Avista Corp's senior unsecured debt and
6 corporate rating were downgraded to below investment grade by Standard & Poor's
7 (S&P), and Moody's Investors Service.

8 **Q. What actions has the Company taken to improve its financial health?**

9 A. We have been aggressively rebuilding our financial health by improving
10 our cash flow, managing our costs and paying down debt. Since 2001, and through the
11 first quarter of 2005, the Company has repurchased approximately $319 million of
12 higher-cost debt.

13 In December 2002, S&P affirmed its credit ratings for Avista and upgraded its
14 credit outlook to stable from negative. In March 2004, Moody's affirmed its credit
15 ratings of Avista and upgraded its ratings outlook to stable from negative.

16 Although we are making progress in improving the Company's financial
17 stability, we are still not as strong as we need to be, which is why the rating agencies are
18 not yet ready to upgrade our credit rating. The current drought condition for 2005 is a
19 good example of why we are still "on the edge." During fourth quarter 2004, as we

[1] Based on Generally Accepted Accounting Principles (GAAP) in existence in 2001.

1 planned for 2005, we forecast that we would have enough operating cash flow to fund
2 our normal level of ongoing capital expenditures. In addition, our forecast suggested
3 that by the fourth quarter we would begin to see interest coverages that would meet the
4 minimum levels required by the rating agencies for investment grade credit levels.
5 Unfortunately, we have experienced drought conditions during 2005. This situation
6 negatively impacts our hydro generation, requiring us to purchase more expensive
7 replacement power and pay higher fuel costs to run our natural gas turbine generation.
8 Moreover, we will not generate enough cash flow from operations to fund our ongoing
9 capital expenditure budget, and we will not hit the minimum coverage levels required
10 by the rating agencies during 2005. It is especially important for us to regain our
11 investment grade rating prior to late 2006 as we look toward refinancing high cost debt
12 in 2007 and 2008. Typically, the rating agencies would first place us on "Positive
13 Outlook" about one year prior to our actual upgrade.

14 **Q. What additional steps is the Company taking to improve its financial**
15 **health?**

16 A. The Company is continuing to rebuild its financial condition in three
17 areas. First, we are working to assure we have adequate funds for operations, for
18 capital expenditures and for debt maturities, through our banks and also by
19 maintaining adequate access to the capital markets. As I discuss later in my testimony,
20 we have worked with our banks to insure that we have adequate liquidity through the

1 availability of our credit facility on the most economic basis possible. We also maintain
2 an ongoing dialogue with the rating agencies regarding the measures being taken by the
3 Company to regain an investment grade credit rating.

4 Second, the Company is exercising a high level of scrutiny with regard to
5 expenses and capital investment in the operation of the business, without compromising
6 safety and reliability.

7 Finally, the Company is working through regulatory processes to recover our
8 costs so that earned returns are closer to those allowed by regulators in each of the
9 states we serve. This is one of the key determinants from the rating agencies'
10 standpoint when they are reviewing our overall credit rating. In fact, in my discussions
11 with the rating agency analysts that follow Avista, they have emphasized that
12 supportive regulation is a major factor in determining a company's creditworthiness.

13 **Q. What is the status of regulatory filings in other jurisdictions related to**
14 **recovery of costs?**

15 • California – In March 2005, the California Public Utilities Commission (CPUC)
16 approved the sale of the Company's South Lake Tahoe natural gas distribution
17 properties to Southwest Gas Corporation. The transaction is expected to close near
18 the end of April 2005. Therefore, as of the end of April, Avista will no longer
19 provide retail service in the State of California. This sale is part of Avista's strategy
20 to focus on its business in the northwestern United States.

1 ▪ Idaho – In October 2004, the Idaho Public Utilities Commission (IPUC) approved
2 electric and natural gas general rate increases of $24.7 million (or 16.9%) electric and
3 $3.3 million (or 6.4%) natural gas. In addition, in January 2005 Avista filed a request
4 with the IPUC to include in base rates the costs associated with the acquisition of the
5 second half of the Coyote Springs 2 (CS2) project, effective April 15, 2005. Approval
6 of Avista's request in Idaho related to CS2, together with the recent general rate
7 increases, would provide the Company with the opportunity to earn its allowed rate
8 of return for its electric and natural gas operations in Idaho under normal operating
9 conditions.

10 ▪ Oregon - In September 2003, the Oregon Public Utility Commission (OPUC)
11 approved a natural gas general rate increase of $6.3 million (or approximately 10%).
12 The rates approved in 2003 continue to provide Avista with the opportunity to earn
13 its allowed rate of return under normal operating conditions.

14 In addition to the recent changes in base electric and natural gas rates, Avista has
15 electric and natural gas tracking mechanisms in all of the states in which it serves. The
16 Company has Purchase Gas Adjustments (PGAs) in Washington, Idaho, Oregon and
17 California, an electric Power Cost Adjustment (PCA) in Idaho, and the Energy Recovery
18 Mechanism (ERM) in Washington. Each of these tracking mechanisms is designed to
19 more closely align the rates paid by customers with the costs to provide service. Mr.
20 Peterson, in his testimony, explains the Company's request to eliminate the $9.0 million

1 "deadband" in the ERM, at least until Avista is able to regain an investment grade
2 credit rating.
3 This general rate request for electric and natural gas in the State of Washington is
4 another important component of the rate relief necessary to provide recovery of costs
5 incurred to serve customers, and improve our financial condition to provide an
6 opportunity to regain an investment grade credit rating.
7 **Q. Please summarize the recent actions the Company has taken with regard**
8 **to its subsidiaries.**
9 A. In 2001 the Company adjusted its corporate strategy to focus on its energy
10 and utility related businesses. Since then, we have completely divested our
11 telecommunications subsidiary, Avista Communications, and sold the majority of
12 Avista Labs, the fuel cell company. We have no further obligations to fund that
13 business. Avista Advantage became cash-flow positive in 2003, virtually requires no
14 cash to fund its operations and had positive earnings for the last two quarters of 2004
15 and year-to-date December 31, 2004.
16 Avista Energy continues to be a solid performer and, in fact, has provided over
17 $170.9 million in cash contributions since 2001 to fund a significant portion of the debt
18 we have repurchased. Our strategy to the future will continue to be focused primarily
19 on the regulated utility and other energy and utility-related businesses.
20

1 **III. CREDIT RATINGS AND PLAN TO RETURN TO INVESTMENT GRADE**

2 **Q. Please explain the ratings for Avista's debt and other securities, and the**
3 **implications of these ratings in terms of the Company's ability to access financial**
4 **markets.**

5 A. Avista's credit ratings by the three principal rating agencies are
6 summarized on page 1 of Exhibit No. ___(MKM-2). For each type of investment a
7 potential investor could make, the investor looks at the quality of that investment in
8 terms of the risk they are taking and the priority that they would have in the event that
9 the organization is unable to meet all of its obligations. Investment risks include the
10 likelihood that a company will not meet all of its obligations in terms of timeliness and
11 amounts owed for principal and interest. Secured debt receives the highest ratings and
12 priority for repayment and, hence, has the lowest relative risk.

13 **Q. What are the risks facing Avista and the rest of the utility sector which**
14 **have an impact on the Company's credit ratings?**

15 A. Among the risk factors are the level and volatility of wholesale market
16 prices, liquidity in the wholesale market (fewer counterparties and tighter credit
17 restrictions), recoverability of natural gas and power costs, streamflow and weather
18 conditions, changes in legislative and governmental regulations, security concerns
19 related to terrorism, and availability of funding.

1 Many of these factors are manifest in the increased earnings volatility the
2 Company has experienced, as well as in the many credit rating downgrades by rating
3 agencies in recent years for utilities across the country. As Mr. Avera explains in more
4 detail in his testimony, the last several years witnessed steady erosion in credit quality
5 throughout the utility industry, both as a result of revised perceptions of the risks in the
6 industry and the weakened finances of the utilities themselves. For example, during
7 2002, S&P recorded 182 downgrades in the utility industry, versus only 15 upgrades,
8 while Moody's downgraded 109 utility issuers and upgraded 3. Credit quality
9 continued to decline during 2003, with S&P reporting that downgrades outpaced
10 upgrades by more than 15 to 1 in the fourth quarter of 2003. While the pace and scale of
11 negative ratings actions has since diminished, S&P reported that the majority of the
12 Companies in the utility sector now fall in the triple-B rating category and noted little
13 likelihood for any significant upturn in credit outlook.
14 **Q. Would you please elaborate on specific risks affecting Avista Utilities?**
15 Available resources and the costs of those resources are significantly affected by
16 low stream flows, weather conditions and high commodity prices faced by the
17 Company. The Company expects hydroelectric generation will be only 80 percent of
18 normal in 2005, assuming normal precipitation for the remainder of the year.
19 For Avista's natural gas resources, Avista does not have any natural gas reserves
20 and purchases all its natural gas requirements in the wholesale market. Natural gas

1 prices in the Pacific Northwest are increasingly affected by supply and demand factors
2 in other regions of the United States and Canada because of growth in transcontinental
3 pipeline capacity. Global energy markets, including oil, also increasingly affect natural
4 gas prices.

5 The earnings impact related to the variability of natural gas prices and below-
6 normal hydroelectric generation is somewhat mitigated through power cost deferral
7 and recovery mechanisms in Washington and Idaho. However, these deferrals
8 negatively impact operational cash flow requirements and may require additional
9 external financings by the Company. Negative impacts to cash flow and additional
10 borrowings adversely affect Avista's interest coverage ratio and increase its debt ratio,
11 which results in a longer time frame for Avista to regain its investment grade credit
12 rating. Rating agencies have warned Avista that, until Avista actually realizes the
13 interest coverage ratio (as described further below), and not just on a projected basis,
14 Avista's corporate credit rating will not be upgraded to investment grade.

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

16 A. Avista Utilities should operate at a level that will support a strong
17 investment grade credit rating, meaning at least a strong "BBB" or weak "A," using
18 S&P's rating scale. This Commission has historically recognized that financially healthy
19 utilities have lower financing costs which, in turn, benefits customers. In addition,
20 financially healthy utilities are better able to invest in the needed infrastructure over

1 time to serve their customers, and to withstand the challenges and risks facing the
2 industry.

3 **Q. Why is it important to be investment grade?**

4 A. A utility is a capital-intensive business and, as such, needs to have ready
5 access to capital markets under reasonable terms. Access is more difficult and more
6 expensive for non-investment grade companies. In many instances, investors are
7 precluded by law, regulation or policy from investing in non-investment grade
8 securities. And, even if you can access the market as a non-investment grade issuer, the
9 cost will be higher. As debt matures and new financing is required in the future to
10 finance utility plant additions and new customer additions, the cost of new and
11 replacement debt will be higher.

12 Non-investment grade companies are also subject to more restrictive credit
13 requirements from vendors and other counterparties. In fact, the Company's ability to
14 purchase power and natural gas has been impacted by the below-investment grade
15 rating, and there are fewer counterparties willing to do business with us. The lower
16 credit rating also requires the Company to post more collateral with those
17 counterparties that are willing to do business with us than would otherwise be required
18 with a higher credit rating. This results in increased costs. The higher costs of financing
19 for being below investment grade ultimately results in higher rates for our customers.

20

1 **Q. What are the credit rating ratios used by the rating agencies?**

2 The Standard & Poor's (S&P's) financial ratio benchmarks used to rate

3 companies such as Avista are set forth below:

Standard & Poor's Financial Ratio Benchmarks*
Table 1

Ratio	AA	A	BBB	BB	(BB+) Avista**
Fund from operations/interest coverage (x)	5.2 - 6.0 (x)	4.2 - 5.2(x)	3.0 - 4.2(x)	2.0 - 3.0(x)	2.36 (x)
Funds from operations/total debt (%)	35 - 45%	28 - 35%	18 - 28%	12 - 18%	10.20%
Total debt/total capital (%)	32 - 40%	40 - 48%	48 - 58%	58 - 62%	59.90%

BBB = investment grade credit rating
** Ranges for companies with a Business Profile of "6", which includes Avista Corp.*
*** As of 12/31/04*

4

5 **Q. Please describe how these ratios are calculated and what they mean?**

6 A. The first ratio, "Funds from operations/interest coverage (x)", calculates

7 the amount of cash from operations that is available to cover interest requirements. The

8 second ratio, "Funds from operations/total debt (%)", calculates the amount of cash

9 from operations as a percent of total debt, and the third ratio, "Total debt/total capital

10 (%)", is the amount of debt in our total capital structure.

11 **Q. Where does Avista fall within those coverage ratios?**

12 As shown in Table 1 above, Avista's corporate rating is currently BB+, or below

13 investment grade.

1 As of December 31, 2004, for the first ratio, "Fund from operations/interest
2 coverage", Avista's rating is 2.36 which is well below the 3.0-4.2 range needed to meet a
3 BBB rating. As discussed previously, progress in increasing this ratio to meet the
4 investment grade level has been slower than anticipated due to reduced stream flows
5 affecting hydro generation, higher thermal fuel costs than what we are currently
6 recovering in rates, and higher capital expenditures that require cash up front before we
7 can recover the costs from customers. Each has an impact on the Company by
8 reducing the amount of available cash flow from operations, requiring external
9 financing and ultimately resulting in higher debt and lower interest coverage ratios.
10 Avista's position as of December 31, 2004, for the second ratio, "Funds from
11 operations/total debt" is 10.2% compared to the 18%-28% needed for investment grade
12 – well below what is required. Avista's rating as of December 31, 2004, for the third
13 ratio, "Total debt/total capital" is 59.9% compared to 48-58% needed for investment
14 grade. For both ratios, to move Avista's ratings within the required range to meet
15 investment grade, Avista must reduce its total debt balances and increase its available
16 funds from operations. Although the Company has continued to work towards paying
17 down its total debt, the negative impacts to cash flow caused by below-normal
18 hydroelectric generation and the variability of natural gas prices, adversely affect
19 Avista's ability to reduce total debt.

1 **Q. Do the rating agencies look at any other factors when evaluating a**
2 **company's credit quality?**
3 A. Yes, they do. The rating agencies evaluate the company's resource
4 picture, the competitive environment in which we operate, the regulatory environment
5 including the timely recovery and certainty of recovery of costs, quality of management
6 and financial policy. Therefore, while the ratios are utilized in their quantitative
7 evaluation of a company, they are not the only factors that are taken into account.
8 **Q. How important is the regulatory environment in which a Company**
9 **operates?**
10 A. According to my discussions with the rating agencies, the regulatory
11 environment in which a company operates is a major factor in determining a company's
12 creditworthiness. As explained further by Mr. Avera, given investors' heightened
13 awareness of the risks associated with the electric power industry and the damage that
14 results when a utility's financial flexibility is compromised, supportive regulation is
15 perhaps more crucial now than at any time in the past.
16 As a further example, Banc of America Securities, in its March 2005 report "The
17 Kaleidoscope Of Power Regulation In Focus" states at pages 3:
18 "In assessing the regulatory climate, we focus on how a state's
19 laws and a commission's policies affect the stability and
20 adequacy of a utility's cash flow and credit quality."
21

They go on, at pages 3-4, to list several qualities or characteristics they believe are consistently found in "credit supportive" State Commissions. The following are among the several characteristics listed by the report:

- **Decisions are Generally Supportive of Credit Quality.** The Commission consistently adopts regulatory policies and makes decisions that have the result of producing strong, stable cash flow and interest coverage.

- **Authorized Return on Equity and Equity Ratios.** Higher authorized returns on equity and higher approved equity ratios in setting the fair rate of return provide higher interest coverages for regulated utilities. It is our view that the utilities that have higher equity ratios than the industry average do so in large part because historically, their state commissions recognize the benefit and permit the companies to pass costs through rates.

- **Adjustment Clauses.** Adjustment clauses for expenses such as fuel and purchased power provide utilities with a greater assurance for the recovery of operating expenses and result in more stable financial results. The more frequent the adjustment, the less working capital that is used to carry deferred costs.

- **Negotiated (positive) vs. Litigated (less positive) Rate Case Settlements.** Companies that can negotiate regulatory settlements generally agree to the terms and present the investment community with fewer negative surprises.

- **Timing.** How quickly can a commission approve new rates if necessary? The shorter the time period the better.

- **Interim Rates.** Does the Commission have the ability to put rates into effect before a final order, subject to refund? The ability to put rates into effect on an interim basis allows the commission to respond quickly to a company's needs and lowers the level of financial uncertainty for the company until a final order is issued.

1 • **Using forecast costs to set rates (good) vs. historical (typically negative).**
2 The more opportunity the company has to base rates on current or
3 forecasted costs, the greater the likelihood that rates will actually produce
4 a fair and adequate return when implemented.
5
6 In the same March 2005 Banc of America Securities report, there is a review of
7 utility commissions in each of the states. The report provides the following assessments
8 at page 61 related to return on equity, the common equity ratio, and Adjustment
9 Clauses in the State of Washington:

10 • **Return on Equity** – Average to slightly lower-than-average awarded
11 returns on equity with capital structures that also reflect lower common
12 equity relative to the capital structures adopted by other states, in our
13 view. (underscores added)
14
15 • **Adjustment Clauses** – Fuel and purchased cost adjustments are
16 permitted, and Puget and Avista have adjustment clauses in place. The
17 current plans subject the utility to the risk/reward of under/over collection
18 of a portion of the change in expected costs before costs are passed on to
19 customers. This "dead band" approach has subjected the utilities to
20 greater earnings volatility than a simple recovery mechanism.
21 (underscores added)
22
23 It is important to the Company that the Commission's order in this case provide
24 the opportunity for Avista to make meaningful progress toward achieving financial
25 ratios that will support investment grade credit ratings as it will be facing significant
26 capital requirements and maturing debt in the next few years. Supportive decisions
27 related to the return on equity, the equity ratio, and elimination of the $9.0 million
28 "deadband" are especially important.
29

1 **IV. CASH FLOW**

2 **Q. What are the Company's near-term capital requirements?**

3 A. As a combination electric and natural gas utility, over the next few years
4 capital will be required for customer growth, necessary maintenance and replacements
5 of our natural gas utility systems, as well as investment in generation, transmission and
6 distribution facilities for the electric utility business.

7 The amount of capital expenditures planned for 2005-2006 is approximately $275
8 million.[2] For 2005 alone, these costs equate to a total of $145 million. A few of the major
9 capital expenditure items include $58 million for transmission and distribution
10 upgrades, $33 million for electric and natural gas customer growth, $11 million for
11 environmental affairs (associated with the Spokane River relicensing and the 2001 Clark
12 Fork River license implementation issues), and $12 million for generation upgrades.

13 Major capital expenditures are a normal part of utility operations. Customers are
14 added to the service area, roads are relocated and require existing facilities to be moved,
15 and facilities continue to wear out and need replacement. These and other
16 requirements create the need for significant capital expenditures each year. Issuance of
17 securities depends upon the Company maintaining a strong capital structure, sufficient

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[2] Capital expenditures planned for 2005-2006 of $275 million excludes the first quarter 2005 expenditure payment of $57.5 million paid for the remaining amount due for the second half of CS2. ($5 million of the total cost for CS2 was paid during 2004.)

1 interest coverage, and investment grade credit ratings to be able to access capital at
2 reasonable costs.

3 **Q. What are the Company's near-term plans related to its debt?**

4 A. As we look to the future, the Company has over 50% (i.e., over $500
5 million) of its total debt maturing in 2007 and 2008, as shown in the chart below. A
6 stronger credit rating would allow the Company to refinance the debt at lower interest
7 rates. Therefore, it is important for the Company to regain its financial health and
8 credit ratings quickly, which will result in lower financing costs for customers in the
9 future.

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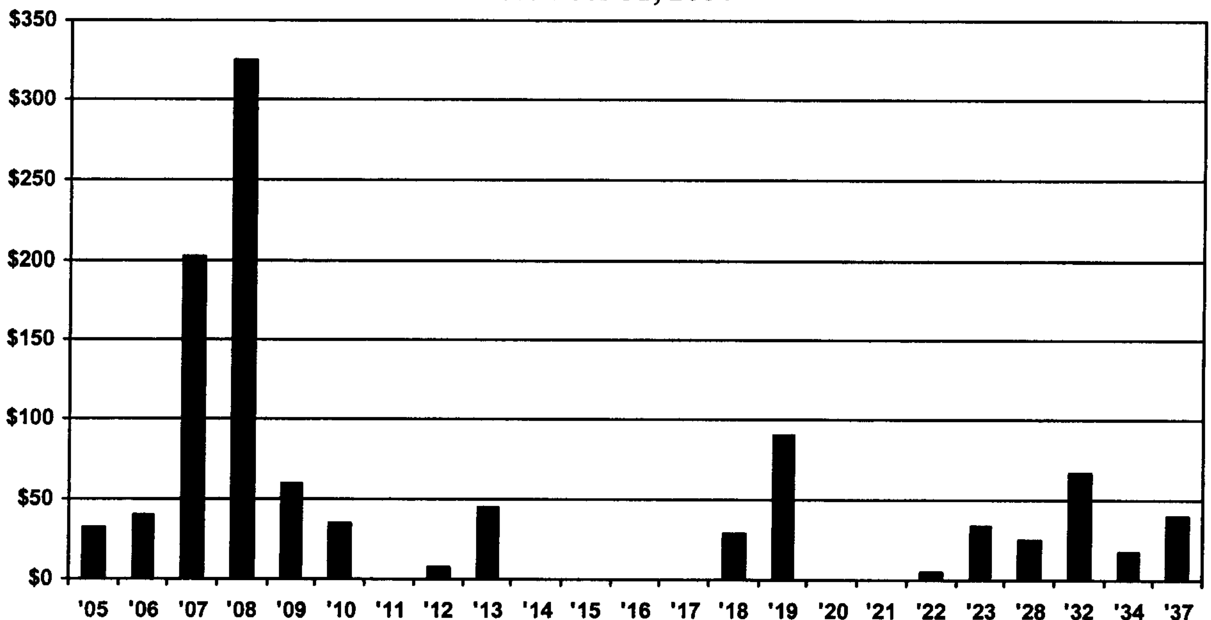

1 **Q. Has the Company taken any steps to address the significant debt**
2 **maturities it faces in 2007/2008?**
3 A. Yes it has. As a result of the historically low interest rate environment that
4 existed in 2004, the Company entered into three forward-starting interest rate swaps
5 totaling $200 million. The swaps include contract terms of seven and ten years. These
6 agreements secured a fixed rate for a significant portion of the total interest that will be
7 paid on this portion of the debt that will be refinanced in 2007 and 2008. By entering
8 into swaps totaling $200 million, we have locked in a significant amount of interest rate
9 certainty for almost 40% of the debt that must be refinanced.
10 **Q. Can you quantify the savings that you expect will be realized when**
11 **these swaps start?**
12 A. Yes. As compared to the interest rates on the existing securities of 7.75%
13 and 9.75%, we expect to realize at least $900,000 of annual interest savings starting in
14 2007, and an additional $3.4 million of annual interest savings starting in mid-2008.
15 **Q. What other financing activities did the Company complete in 2004 that**
16 **will lower its interest costs?**
17 A. The Company refinanced $60 million of 7.875% Trust Preferred Stock in
18 April 2004. For the next five years, the interest rate will be 6.50%, which results in
19 approximately $750,000 in annual savings. Such savings have been reflected in the cost

1 of Trust Preferred Securities in our proposed cost of capital. In addition, in November
2 2004, the Company issued $90 million of 15-year First Mortgage Bonds at 5.45%.

3 **Q. What is the status of the Company's line of credit?**

4 A. The bank market has improved in the last year. In 2002, we had to secure
5 our credit line with First Mortgage Bonds whereby the banks now have the same
6 ranking in priority as our other First Mortgage Bond holders. While our financial
7 condition has improved, the banks continue to require the safety of a line secured by all
8 of our utility property. The facility needs to be large enough to allow the Company to
9 fund at least one year of capital expenditures, plus required working capital and
10 counterparty collateral requirements to assure flexibility given volatile financial
11 markets, and especially given the recent volatility of energy commodity costs.

12 Many purchases of natural gas, or contracts for pipeline capacity to provide
13 natural gas transportation, have required collateral, or prepayments, given the
14 Company's credit rating. The line of credit is our only source of immediate cash for
15 borrowing to meet these needs and for supporting the use of letters of credit. We need
16 a line of credit just to manage daily cash flow since the timing of cash receipts versus
17 cash disbursements is never totally balanced. As the company's gas procurement
18 services (Natural Gas Benchmark Mechanism) is transitioned back to the Utility from
19 Avista Energy effective April 1, 2005, credit requirements have increased substantially
20 and will continue to increase at the Utility.

1 In May 2004, the Company's line of credit was amended to increase the available
2 amount from $245 million to $350 million and the expiration date was extended to May
3 2005. The credit line was increased to accommodate possible increases in liquidity
4 requirements and the potential for consolidations within the banking industry. In
5 December 2004, the Company renegotiated its $350 million corporate line of credit,
6 lowering the borrowing costs (providing over $1 million of interest savings annually)
7 and extended the term to five years. The agreement also now includes the option to
8 release the first mortgage bond security if the Company regains its investment grade
9 credit rating. This demonstrates recognition by our banks that Avista's financial
10 condition is improving.

11 **Q. What are Avista's plans regarding common equity and why is this**
12 **important?**

13 A. Avista needs to improve the common equity ratio of its capital structure.
14 The company is accomplishing this by continuing to reduce debt, as well as improving
15 retained earnings.

16 We do not have current plans to issue equity, other than the small amounts to
17 fund the requirements of our dividend reinvestment and employee benefit plans, and
18 are concentrating on lowering our debt ratio and improving the common equity ratio
19 through current cash flows. The Company's equity ratio at December 31, 2004 was
20 approximately 41%. During the 12-month proforma period ending December 31, 2006,

1 the equity ratio is expected to increase to 45.44%. However, the 44.0% proforma equity
2 ratio the Company is utilizing in this case is an average of quarter-ending information
3 for December 31, 2005 through December 31, 2006. This produces the same result for
4 Avista as the recent equity ratio methodology approved by the WUTC Commission for
5 Puget Sound Energy, Inc., in Docket Nos. UG-040640 and UE-040641 (consolidated).
6 The more flexibility the Company has by maintaining access to both the debt and
7 equity markets, the stronger our financial condition will become. The opportunity to
8 earn our allowed return on equity will continue to build the equity ratio, and improve
9 the Company's financial condition. It is also important to have a higher common equity
10 ratio in the event adverse conditions exist.
11
12 **V. CAPITAL STRUCTURE**
13 **Q. Please explain the capital structure proposed by Avista in this case.**
14 A. Avista's capital structure consists of a blend of long-term debt, short-term
15 debt, trust preferred securities, preferred equity and common equity necessary to
16 support the assets and operating capital of the Company. The proportionate shares of
17 Avista Corp's actual capital structure on December 31, 2004, are shown on page 2 of
18 Exhibit No. __(MKM-2). A pro forma capital structure is also shown in the Exhibit,
19 which reflects expected changes based on an average of quarter-ending information for

1 the period December 31, 2005 through December 31, 2006. Supporting workpapers
2 provide additional details related to these adjustments.
3 The rate of return to be applied to rate base in this proceeding is equal to the
4 weighted average cost of capital, taking into account the pro forma adjusting items. As
5 shown on page 2 of Exhibit No. __(MKM-2), Avista Utilities is proposing an overall rate
6 of return of 9.67%.
7
8 **VI. COST OF DEBT**
9 **Q. How have you determined the cost of debt?**
10 A. Cost of debt in the Company's proposed capital structure includes both
11 long-term and short-term debt. As shown on page 2 of Exhibit No. ___(MKM-2), the
12 actual weighted average cost of debt outstanding on December 31, 2004 was 8.27%. The
13 size and mix of debt funding changes over time. We have made certain pro forma
14 adjustments to update the debt cost through December 31, 2005 to 8.44%. The proforma
15 weighted cost of debt was reduced from 4.33% to 4.17%.
16 Proforma adjustments to long-term debt reflect expected maturities of
17 outstanding debt, required preferred sinking fund purchases, changes in interest rate on
18 trust preferred securities and the January and February 2005 repurchases of $26 million
19 of Medium-Term notes.

1 The level of short-term debt is based on the average short-term debt balances, by
2 quarter, between December 31, 2005 and December 31, 2006. The cost of short-term
3 debt is based on our costs of borrowing under our corporate credit facility along with a
4 forward curve of short-term LIBOR rates. This estimated forward curve is based on
5 information accessed through Bloomberg market information. Supporting workpapers
6 provide additional details related to these adjustments.
7
8 **VII. COST OF PREFERRED EQUITY**

9 **Q. What is the role of preferred equity in Avista Utilities' long-term capital**
10 **structure?**

11 A. Preferred equity securities have attributes that are similar to both debt and
12 to common equity. Certain investors are interested in owning preferred securities
13 rather than common equity because of the greater certainty of a specified return on
14 preferred securities. Preferred securities often have a longer term or an indefinite
15 maturity than typical debt securities, which is attractive to certain investors. Because of
16 their unique niche in the capital structure, preferred securities have specific covenants
17 and restrictions that must be carefully considered in light of long-term financing needs
18 and the ability to adapt to changing situations. In the past, the Company has been able
19 to issue preferred securities with costs and terms that are advantageous to our capital
20 structure.

1 However, there is a limited capacity to use preferred equity as part of the overall
2 capital structure. The rating agencies assign various levels of "equity credit" to
3 preferred equity depending on the specific structure and the Company's credit rating.
4 The higher the credit rating, the lower the level of equity treatment given and vice
5 versa. In addition, Generally Accepted Accounting Principles (GAAP) changed in 2003
6 whereby Trust-Preferred Securities are now treated as "debt" on the balance sheet.
7 While the Company currently has about 6.60% (5.18% + 1.42%) of its capital structure in
8 preferred securities, to the future, we will be focusing more on improving the common
9 equity ratio and reducing the total debt ratio rather than specifically focusing on a
10 targeted preferred stock ratio target.

11 **Q. How does preferred equity affect the rate of return?**

12 A. Preferred equity, which includes both trust preferred securities and
13 preferred stock, comprised 6.60% of Avista Utilities' capitalization, including proforma
14 adjustments through December 31, 2006. We have included the actual cost of preferred
15 equity in our calculation of weighted average cost of capital shown on page 2 of Exhibit
16 No. ___(MKM-2).

17

18 **VIII. COST OF COMMON EQUITY**

19 **Q. What rate of return on common equity is the company proposing in this**
20 **proceeding?**

1 A. The company is proposing an 11.5% return on common equity (ROE). Dr.
2 William Avera testifies to analyses related to the cost of common equity for a
3 benchmark group of utilities in the western U.S., with an ROE range of 11.1% to 12.1%.
4 In his testimony Dr. Avera states that:

5 Considering Avista's specific risks, coupled with expectations of
6 higher bond yields going forward, I concluded that the 11.5
7 percent ROE requested by Avista is a conservative estimate of
8 investors' required rate of return for the Company in the 2006
9 rate year. (P. 53, L. 8)
10
11 Moreover, an 11.5 percent rate of return on equity is reasonable at
12 this critical juncture, given the importance of supporting the
13 financial capability of Avista as it seeks to achieve an investment
14 grade credit rating and attract the capital necessary to develop
15 and enhance utility infrastructure. The cost of providing Avista
16 an adequate return is small relative to the potential benefits that a
17 strong utility can have in providing reliable service. (P. 55, L. 5)
18

19 **Q. Dr. Avera suggests that an ROE of more than 11.5% is warranted.**
20 **Why is Avista not requesting an ROE greater than 11.5%?**

21 A. As I have testified, the Company has made progress in its efforts to regain
22 financial health. If Avista can earn an 11.5% ROE in 2006, I believe the financial results
23 would support a bond rating upgrade to investment grade within a reasonable period
24 of time.

25 Furthermore, as the Company has worked toward regaining its financial health
26 over the last several years, it has done so with the customer in mind. Avista has

1 attempted to balance the time frame for financial recovery with the impacts that
2 increased retail rates have on its customers.

3 In this case, although we believe an ROE greater than 11.5% is supported and is
4 warranted, we also believe the 11.5% provides a reasonable balance of the competing
5 objectives of regaining financial health within a reasonable period of time, and the
6 impacts that increased rates have on our customers.

7 **Q. Please summarize the proposed capital structure and the cost**
8 **components for debt, preferred, and common equity.**

9 A. As also shown on page 2 of Exhibit No. ___(MKM-2), the following table
10 shows the capital structure and cost components proposed by the Company.

11

	Component	Percentage	Cost	Weighted Cost
12				
13	Component	Percentage	Cost	Weighted Cost
14				
15	Total debt*	49.40%	8.44%	4.17%
16	Trust preferred securities	5.18%	6.60%	0.34%
17	Preferred equity	1.42%	7.39%	0.10%
18	Common equity	44.00%	11.50%	5.06%
19				
20	Total Weighted Cost of Capital	100.00%		9.67%
21	*includes short-term debt			

22

23

24 **Q. Does that conclude your prefiled direct testimony?**

25 A. Yes.