BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. U-170970

SUPPLEMENTAL DIRECT TESTIMONY OF

CHRISTOPHER F. LOPEZ

REPRESENTING HYDRO ONE

IN SUPPORT OF SETTLEMENT STIPULATION

April 10, 2018

I. INTRODUCTION

Q. Please state your name, business address, and present position with Hydro One Limited.

A. My name is Christopher F. Lopez. My business address is 483 Bay Street, South Tower, 8th Floor, Toronto, Ontario M5G 2P5. I am Senior Vice President of Finance for Hydro One Limited ("Hydro One").

Q. Did you file direct testimony in this proceeding?

A. Yes. The purpose of my direct testimony (Exh. CFL-1T), which I incorporate herein by reference, was to:

- describe the merger ("Proposed Transaction");
- discuss Hydro One's corporate structure and where Avista Corporation ("Avista") will reside within that structure;
- discuss Hydro One's capital structure and financial strength;
- describe Hydro One's financing for, and the mechanics of, the Proposed Transaction;
- describe Avista's post-transaction access to capital;
- enumerate certain financial, structural, and ring-fencing commitments that Hydro One and Avista are proposing as part of their request for approval of the Proposed Transaction; and
- describe the Rate Credits included as part of the Proposed Transaction.

Q. What is the purpose of your supplemental direct testimony?

A. The purpose of my supplemental direct testimony is to describe:

- the charitable and community contributions provided by Hydro One and Avista in the Settlement;
- the simplified post-close corporate structure proposed as part of the Settlement;

- commitments made by Hydro One and Avista as part of the Settlement to bolster Avista's capital structure and financial integrity;
- the limited leverage to be used in the merger and Avista's consequent protection from attendant risks;
- commitments made by Hydro One and Avista as part of the Settlement to strengthen the already robust ring-fencing provisions; and
- the revised Rate Credit proposal that significantly increases the immediate financial benefits customers will receive as part of the Proposed Transaction.

Q. Please summarize your supplemental direct testimony.

A. My testimony first discusses Hydro One's and Avista's planned charitable and community contributions following the completion of the merger. Hydro One and Avista are each independently committed to charitable and community involvement, as will continue to be demonstrated in their joint, post-merger endeavors. My testimony will then address the post-merger corporate structure, as well as the plans for the maintenance of Avista's financial health and integrity. Not only will Avista benefit from ring-fencing commitments and restrictions on upward dividend distributions, the company will maintain its autonomy via the appointment of independent directors to the board. Lastly, I will detail recent changes to our Rate Credit commitment, all of which will be to the benefit of Washington's ratepayers.

A table of contents of my supplemental direct testimony is as follows:

Description **Page**

II. CHARITABLE AND COMMUNITY CONTRIBUTIONS

Q. Has Hydro One committed to providing charitable contributions at the close of the Proposed Transaction?

A. Yes. In Commitment 64, Hydro One has committed to causing Avista to make a one-time $7,000,000 contribution to Avista's charitable foundation at or promptly following closing. This contribution will not be recovered through rates for customers of Avista or Hydro One.

Q. **Have Hydro One and/or Avista committed to providing other charitable and community contributions as part of the Proposed Transaction?**

A. Yes. Commitment 11 provides that for five years after the close of the Proposed Transaction, Avista will maintain a $4,000,000 annual budget for charitable contributions, funded by both Avista and the Avista Foundation, and an additional $2,000,000 annual contribution will be made to Avista's charitable foundation. Again, these contributions will not be recovered through rates for customers of Avista or Hydro One.

Q. Will Hydro One and/or Avista continue to make charitable and community contributions at the close of the five year period provided for in Commitment 11?

A. As described in Commitment 1, Authority Reserved, and in Commitment 11, Community Contributions, that decision is reserved to the Avista Board. That said, it would be consistent with Avista's past and current practices and Hydro One's past and current practices for Avista to continue to make charitable and community contributions at the close of the five-year period mentioned in Commitment 11. It would also be consistent with Commitment 12 on Community Involvement for charitable and community contributions to continue well into the future. The exact amount of those contributions is left to the determination of the Avista Board.

III. POST-CLOSE CORPORATE STRUCTURE

Q. As part of the Settlement, has Hydro proposed a change to the post-transaction corporate structure presented in the Joint Application?

A. Yes.

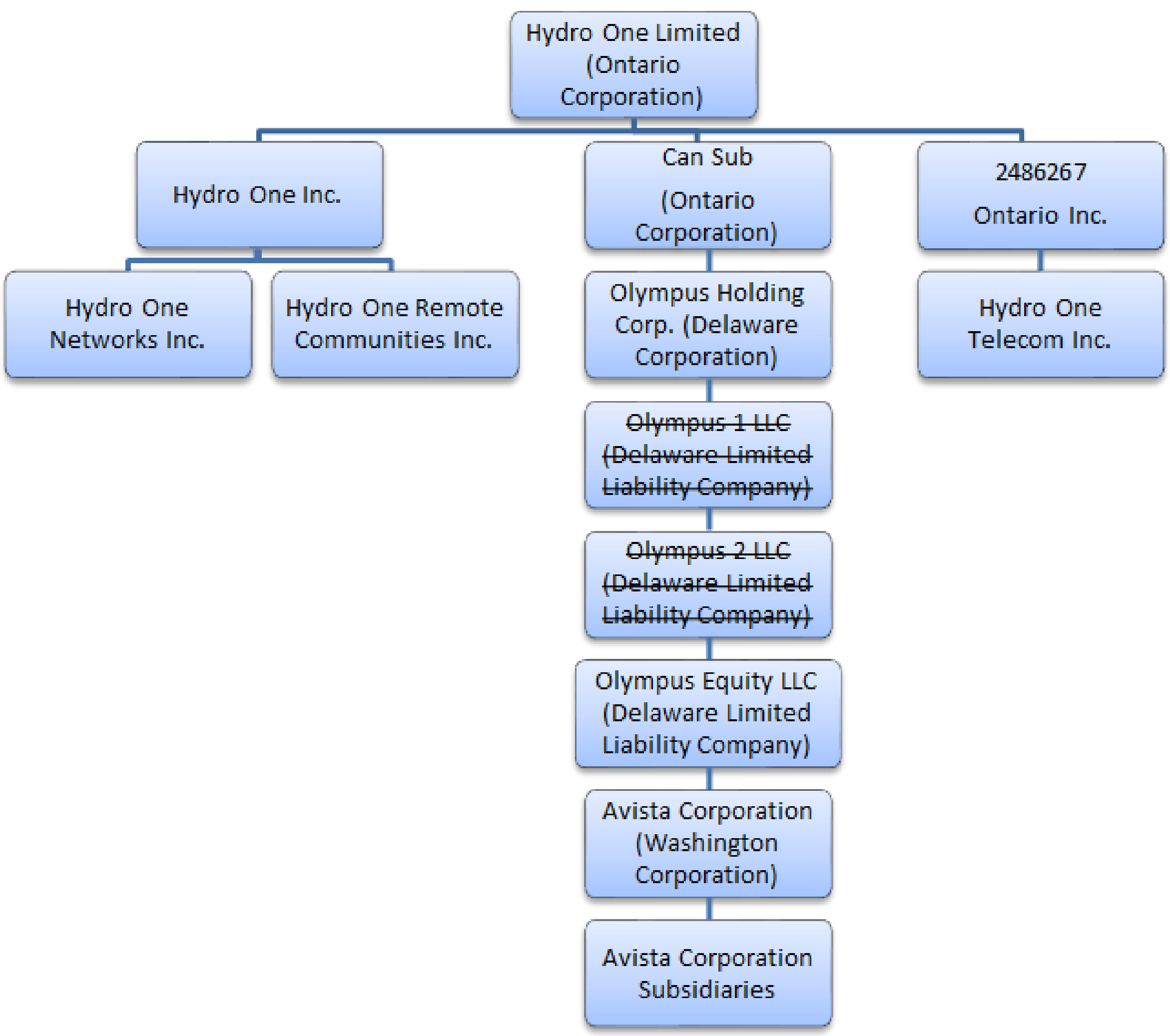
Q. Can you please describe that change?

A. The change simply involves the removal of two limited liability companies, Olympus 1 LLC and Olympus 2 LLC, which were originally proposed in the corporate chain of ownership. The other entities remain unchanged. Both the structure proposed in the September 2017 Joint Application and the simplified structure under the Settlement Agreement provide segregation between the rate-regulated business in the United States, which would be held by Can Sub and Olympus Holding Corp., and the Ontario rate-regulated business, which is held by Hydro One Inc. Under both the original and simplified structure, upon completion of the Proposed Transaction, Avista will be an indirect, wholly-owned subsidiary of Hydro One. Under both structures, after closing, Avista will be a direct, wholly-owned subsidiary of Olympus Equity LLC, a bankruptcy-remote entity with no debt. Hydro One proposed this structure, together with the ring-fencing provisions described in my direct testimony (and now with the revisions that are described later in this supplemental testimony), to ensure that Avista and its customers would be insulated from any potential financial distress at Olympus Equity LLC or other entities up the chain from Olympus Equity LLC.

Q. Do you have organizational charts that reflect the difference between the structure as originally proposed and the current structure?

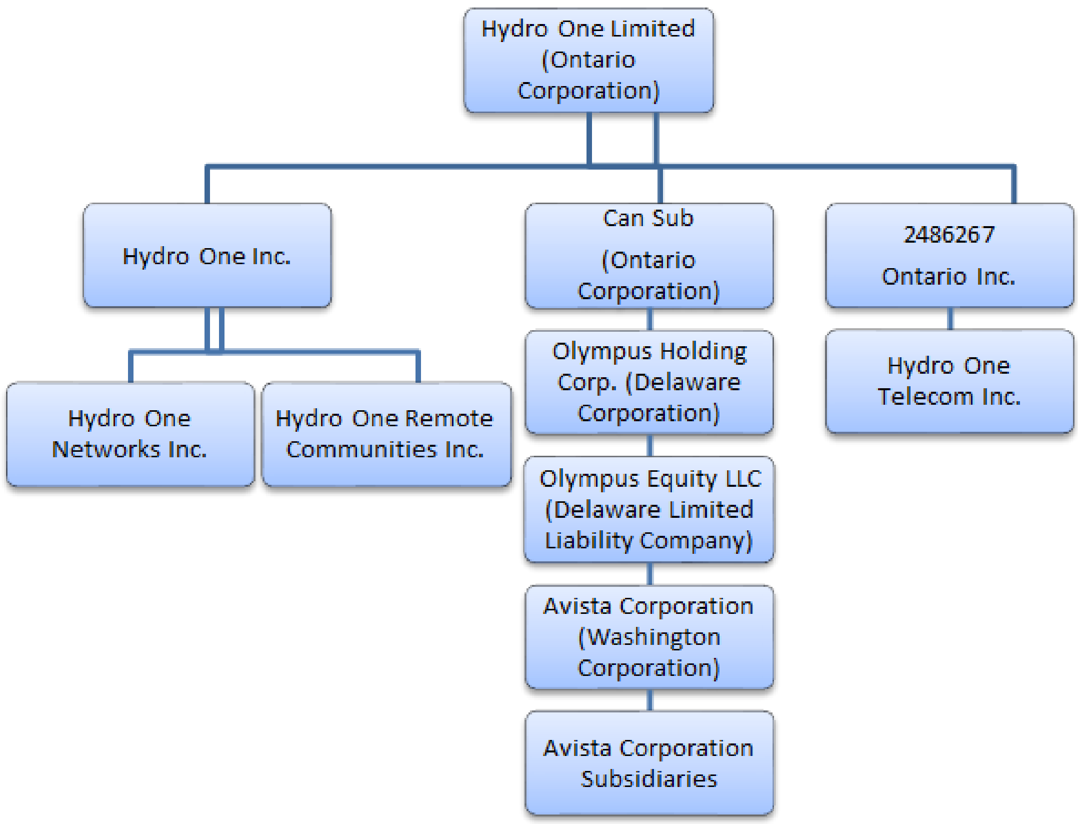
A. Yes. The following organizational chart, which was also included as Appendix 1 to the Joint Application and as Exh. CFL-3 to my direct testimony, shows the structure as originally proposed, but we are proposing to eliminate the two LLCs, as demonstrated via the strikethrough text below:

<u>Illustration No. 1</u>



The simplified post-closing corporate structure as described in the Settlement Stipulation is illustrated in the following organizational chart:

Illustration No. 2



Q. Why is Hydro One proposing to remove Olympus 1 LLC and Olympus 2 LLC from the post-close corporate structure?

A. As explained in my direct testimony, Olympus 1 LLC and Olympus 2 LLC were created for Canadian tax planning purposes and to manage the flows of intercorporate funds. As a result of U.S. federal tax reform, however, these entities are no longer necessary. Hydro One is proposing to remove these two LLCs in order to simplify the post-closing corporate structure.

Q. Is Hydro One proposing any other changes to the post-close corporate structure or to the entities in that structure?

A. No. For the reasons described above and in my direct testimony, the rest of the post-close corporate structure remains intact, and the entities in the post-close corporate structure, other than Olympus 1 LLC and Olympus 2 LLC, will perform the same functions and roles as described in my direct testimony.

IV. AVISTA'S CAPITAL STRUCTURE AND FINANCIAL INTEGRITY

Q. As part of the Settlement, did Hydro One make additional commitments or strengthen any of the commitments presented in the Joint Application related to Avista's capital structure and financial integrity?

A. Yes. Hydro One agreed to revisions to its commitments regarding Avista's capital structure, restrictions on upward dividends and distributions, and pension funding. Hydro One also agreed to add a new Commitment 37 regarding credit ratings notification.

Q. Please describe the changes made to Commitment 26, "Avista Capital Structure."

A. As part of the Settlement, Commitment 26 was revised to state that "Avista's actual common equity ratio will be maintained at a level no less than 44 percent." It was also edited to clarify that it "does not restrict the Commission from ordering a hypothetical capital structure."

Q. Please describe the changes made to Commitment 38, "Restrictions on Upward Dividends and Distributions."

A. In the Joint Application, Hydro One and Avista had proposed to allow upward dividends and distributions where Avista's corporate credit/issuer rating was investment grade (scenario 1) or where the ratio of Avista's EBITDA to Avista's expense interest was greater than or equal to 3.0 (scenario 2), so long as Avista's equity ratio was equal to or greater than 44 percent on the date of such Avista distribution, after giving effect to such Avista distribution, except to the extent the Commission established a lower equity ratio for ratemaking purposes.

To strengthen this commitment, Commitment 38.a now provides that upward distributions from Avista to Olympus Equity LLC are permitted under scenario 1 only if "***both*** Moody's and S&P, or their successors" determine Avista's corporate/credit issuer rating is investment grade. Moreover, under Commitment 38.c, if both scenario 1 and scenario 2 are not achieved, then upward dividends will not occur: "If Avista does not have an investment-grade rating from both Moody's and S&P, or from one of these entities, or its successor, if only one issues ratings with respect to Avista, ***and*** the ratio of EBITDA to Avista's interest expense is less than 3.0, no dividend distribution to Olympus Equity LLC or its successors will occur."

Q. What changes did Hydro One make to Commitment 39, "Pension Funding"?

A. In Commitment 39 to the Settlement, Hydro One has agreed that it will not seek to change Avista's pension funding policy.

Q. What have Hydro One and Avista committed to in new Commitment 37, "Credit Ratings Notification," to the Settlement?

A. To bolster their commitments in the Joint Application to maintain separate credit ratings and to restrict dividends and distributions based on credit ratings for Avista, Hydro One and Avista agreed to add Commitment 37. It requires Hydro One and Avista "to notify the Commission within two business days of any downgrade of Avista's credit rating to a non-investment grade status by S&P, Moody's, or any other such ratings agency that issues such ratings with respect to Avista."

Q. Will Avista remain a financially strong utility post-merger?

A. Yes, as described in detail in my direct testimony, Avista will be a financially sound company post-merger. That is in the best interests of Avista's customers, Avista, and Hydro One. The commitments proposed in the Joint Application, and as revised during settlement negotiations, ensure that post-closing, Avista will have access to capital from the markets and capital structure support from Hydro One, and will maintain a healthy capital structure at the utility level.

Q. Is Hydro One's potential acquisition of Avista subject to substantial leverage?

A. No. Hydro One's acquisition of Avista is not a highly leveraged transaction. The financing of the merger is based on a mix of debt and equity. The convertible debentures issued by Hydro One to finance the transaction should be viewed as equity, not as debt, because these debentures will be converted into equity at the time of closing. Moreover, Hydro One is financially strong and is viewed by credit rating agencies as a prudent, well-managed company. This is demonstrated by Hydro One Inc.'s strong investment grade credit ratings from Moody's Investors Service ("Moody's"), Standard & Poor's ("S&P"), and DBRS. Hydro One Inc. has an A" long-term credit rating from S&P, an "A3" rating on senior unsecured debt from Moody's, and an "A" (high) rating from DBRS. Hydro One Ltd. has an "A" long-term credit rating from S&P. By comparison, Avista's credit ratings are "BBB" from S&P and "Baa1" from Moody's.

Due to the financial strength and solid investment grade credit ratings of Hydro One, the transaction was well-received by rating agencies for Avista, with S&P revising the outlook for Avista to Positive from Stable. In its report announcing the revised outlook, S&P explains the rationale for the Positive outlook for Avista as follows:

> The outlook revision on Avista reflects the potential for higher ratings upon the completion of the acquisition by Hydro One Ltd. (HOL). Post-acquisition, we will view Avista as a highly strategic subsidiary of HOL. Our assessment is based on our view that Avista will be an important member of the HOL group, highly unlikely to be sold, and integral to overall group strategy and operations. Avista will be a significant cash flow contributor to the group, making up about 22% of consolidated EBITDA. We would also see a strong, long-term commitment of support from HOL senior management in almost all circumstances.

Q. Could the additional leverage at the holding company level adversely affect Avista's risk profile?

A. No. The ring-fencing conditions agreed to by Hydro One and Avista insulate Avista from any negative effects of leverage at the holding company. The Commission will continue to have regulatory authority over Avista and will ensure that customer rates in Washington are not affected by the proposed merger. Any variability in Avista's earnings will only affect Hydro One and its shareholders, if it limits the ability of Avista to pay dividends to Hydro One. There will be no effect on regulated utility operations in Washington as a result of debt used to finance the acquisition.

Q. Will the merger result in a debt-heavy financial structure, i.e., that Avista will be owned by a debt-encumbered holding company?

A. No, for several reasons. First, as stated above, the convertible debentures issued by Hydro One should be viewed as equity because they will be converted to equity at the time of closing. Second, at the Olympus Holding Corp. level, equity will comprise more than half of the capital structure. Third, Avista will be protected by the robust ring-fencing provisions that are described in greater detail below.

V. RING-FENCING

Q. As part of the Settlement, did Hydro One make additional ring-fencing commitments or strengthen any of the ring-fencing commitments presented in the Joint Application?

A. Yes. Although Hydro One feels the ring-fencing commitments and protections offered in the Joint Application—all of which were fully described in my direct testimony—would establish a strong Avista, well-protected from any financial struggles of other entities in the Hydro One corporate family above Avista, Hydro One nevertheless agreed to go above and beyond those protections as part of the Settlement. In the Settlement, Hydro One agreed to:

- add a Golden Share requirement for Avista to enter into a voluntary bankruptcy proceeding (Commitment 42);
- revise the Independent Directors commitment to clarify that the Golden Share requirement is in addition to—and not a substitute for—the vote of an independent director required for including Avista in a voluntary bankruptcy proceeding (Commitment 43);
- add Hydro One to certain of the commitments (Commitment 44 (Non-Consolidation Opinion) and Commitment 49 (No Amendment of Ring-Fencing Provisions);

- strengthen Commitment 46 (Restriction of Pledge of Utility Assets) and Commitment 47 (Hold Harmless; Notice to Lenders; Restriction on Acquisitions and Dispositions); and
- add Commitment 50 (No Inter Company Debt) and Commitment 51 (No Inter Company Lending).

Q. Can you describe new Commitment 42 requiring the vote of a "Golden Share" to include Avista in voluntary bankruptcy proceedings?

A. Yes, new Commitment 42 of the Settlement introduces a "Golden Share" concept into the ring-fencing provisions that requires the issuance of a single share of Preferred Stock of Avista, known as a "Golden Share," for bankruptcy purposes. This "Golden Share" must be in the custody of an independent third party and must be voted in the affirmative for Avista to enter into voluntary bankruptcy proceedings. The independent third party holding the "Golden Share" must have no financial stake, affiliation, relationship, interest, or tie to Avista or any of its affiliates, or any lender to Avista, or any of its affiliates. In matters of voluntary bankruptcy, this "Golden Share" will override all other outstanding shares of all types or classes of stock.

Q. Can you explain the revisions to Commitment 43, "Independent Directors"?

A. Yes. As originally proposed, this commitment required the vote of an independent director to include Avista in voluntary bankruptcy proceedings. Hydro One and Avista agreed to revise this commitment to clarify that inclusion of Avista in a voluntary bankruptcy requires both the vote of an independent director ***and*** the vote of the Golden Share in Commitment 42.

Note also that with regard to the independent directors of the Avista Board, Hydro One and Avista agreed to revise Commitment 3 (Board of Directors) as part of the Settlement. In the Joint Application, Commitment 3 required that three (3) directors of the Avista Board be individuals "who are not officers, employees or directors (other than as an independent director of Avista or Olympus Equity LLC) of Hydro One or any of its affiliates." Hydro One and Avista revised this commitment to provide that those three (3) directors must "meet the standards for 'independent directors' - under section 303A.02 of the New York Stock Exchange Listed Company Manual (the 'Independent Directors')." This revision resolves any doubt, real or imagined, that, in addition to the "Golden Share," a truly independent director will have to vote in the affirmative to include Avista in a voluntary bankruptcy proceeding.[1]

Q. Can you describe the revisions to Commitment 44, "Non-Consolidation Opinion"?

A. Yes. As originally proposed, this commitment required the filing of a non-consolidation opinion with the Commission stating that the ring-fencing provisions are sufficient that a bankruptcy court would not order the substantive consolidation of the assets and liabilities of Avista with those of Olympus Holding Corp. or its affiliates or subsidiaries (other than Avista and its subsidiaries). As part of the Settlement, Hydro One agreed to revise this commitment to require Hydro One, along with Olympus Holding Corp., to "file an affidavit with the Commission stating that neither Hydro One,

[1] Note that the Parties to the Settlement included Exh. JNT-5 to the Joint Testimony in Support of the Settlement Stipulation, which is an errata to Commitment 43. The revised language ensures that the requirement regarding Independent Directors in Commitment 3 is carried through to Commitment 43.

Olympus Holding Corp. nor any of their subsidiaries, will seek to include Avista in a bankruptcy without the consent of a two-thirds majority of Avista's board of directors including the affirmative vote of Avista's independent director, or, if at that time Avista has more than one independent director, the affirmative vote of at least one of Avista's independent directors."

Q. Can you explain the changes to Commitment 49, "No Amendment of Ring-Fencing Provisions"?

A. Yes. Hydro One agreed to revise this commitment to confirm that Hydro One commits that no material amendments, revisions, or modifications will be made to the ring-fencing provisions without prior Commission approval.

Q. Can you explain the revisions to Commitment 46, "Restriction on Pledge of Utility Assets"?

A. Yes. As originally proposed, this commitment precluded Avista from loaning or pledging utility assets to Hydro One, Olympus Holding Corp., or any of their subsidiaries or affiliates, without Commission approval. As part of the Settlement, Hydro One and Avista commit that "Avista's assets will not be pledged by Avista or any of its affiliates, including Hydro One and Olympus Holding Corp. and any of their subsidiaries or affiliates, for the benefit of any entity other than Avista."

Q. Can you describe the changes made to Commitment 47, "Hold Harmless; Notice to Lenders; Restriction on Acquisitions and Dispositions"?

A. Hydro One and Avista agreed to revise this commitment to confirm that Avista will hold Avista customers harmless from any business and financial risk exposures associated with Olympus Holding Corp., Hydro One, and Hydro One's affiliates.

Hydro One and Avista also agreed to revisions related to the requirement to notify the Commission of any change in control or ownership of Avista. Notice of a change to the upstream ownership of Avista or Olympus Holding Corp. among wholly owned subsidiaries of Hydro One may be provided in either an updated organizational chart included in the annual report filing described in Commitment 32 of the Settlement or in a separate notice filing.

Finally, Hydro One and Avista agreed to revise Commitment 47 to specify that within sixty (60) days of the notice required by 47.c.ii.2, "Avista and Olympus Holding Corp. or its affiliates, as appropriate, will seek Commission approval of any sale or transfer of any material part of Avista, or of any transaction or series of transactions, regardless of size, that would result in a person or entity, other than a wholly owned subsidiary of Hydro One, directly or indirectly, acquiring a controlling interest in Avista or Olympus Holding Corp."

Q. **Can you describe new Commitment 50, "No Inter Company Debt"?**

A. Yes, new Commitment 50 requires Avista to notify the Commission "before entering into any inter-company debt transactions with Olympus Holding Corp., Hydro One, or any of their subsidiaries or affiliates."

Q. Can you describe new Commitment 51, "No Inter Company Lending"?

A. Yes, new Commitment 51 prohibits Avista from lending money to Olympus Holding Corp., Hydro One, or any of their subsidiaries or affiliates without prior Commission approval.

Q. Do the ring-fencing provisions in the Settlement protect Avista and its customers from financial distress in other parts of the Hydro One corporate structure?

A. Yes. The ring-fencing provisions offered by Hydro One and Avista in the Settlement are state-of-the-art and as robust as ring-fencing commitments provided in comparable utility mergers and acquisitions in jurisdictions throughout the United States. Avista is wholly protected from bankruptcy proceedings potentially originating from other parts of the Hydro One corporate family.

VI. RATE CREDITS

Q. Did Hydro One and Avista increase the proposed Rate Credit as part of the Settlement?

A. Yes. As part of the Settlement, Hydro One and Avista agreed to a substantial increase in the Rate Credit (Commitment 19 in the Settlement). The Parties increased the total Washington-share of the Rate Credit from approximately $20 million to approximately $31 million. The period of the rate credit payout was shortened from ten (10) to five (5) years, resulting in a $6.1 million annual Rate Credit in Washington. Avista also agreed to reduce the portion of the Rate Credit that was offsetable and to seek Commission approval before applying offsetable savings against the rate credit, in an amount up to $1.02 million per year. Avista bears the burden of proof to show that savings have materialized and that the offset to the Rate Credit should apply.

Q. Will customers receive the full amount of the Rate Credits agreed to in the settlement?

A. Yes. The settlement agreement specifies that Washington customers will receive $30.7 million in Rate Credits over a five year period beginning after the transaction close. Initially, these Rate Credits will take the form of a separate tariff rider with a credit to customers' bills.[2] Pursuant to the settlement, a portion of the separate Rate Credit tariff may be offset (the offsetable portion), but only to the extent customers' base rates have been reduced by savings realized as a result of the merger. If Avista demonstrates in a future Washington rate proceeding that base rates are reduced by merger-related savings, those savings would no longer need to be reflected as part of the separate Rate Credit. In addition, the settlement agreement limits the offsetable portion to just $5 million over five years. In effect, Washington customers are guaranteed to receive at least $31 million in Rate Credits over 5 years due to the transaction.

Q. Does this conclude your direct testimony?

A. Yes, it does.

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[2] Assuming that merger-related cost savings have not already been reflected in base retail rates for Avista's Washington customers.