

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-06\_\_\_\_\_

DIRECT TESTIMONY OF

MALYN K. MALQUIST

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

1  
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 and Chief Financial Officer.

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

8 A. I received both a Bachelor's degree and a Master of Business  
9 Administration degree from Brigham Young University. I have also attended a variety  
10 of utility finance courses and leadership programs during my 25+ year utility career.

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.  
13 Prior to joining Avista, I was General Manager of Truckee Meadows Water Authority in  
14 Reno, Nevada, which was separated out from Sierra Pacific Power Company in 2001.  
15 Before that I was Chief Executive Officer of Data Engines, Inc., a high tech company  
16 located in Reno, from June to October of 2000. From April 1994 to April 2000, I was  
17 employed by Sierra Pacific Resources, first as their Chief Financial Officer and later as  
18 its Chairman of the Board and Chief Executive Officer. Following the merger of Sierra  
19 Pacific Resources with Nevada Power Company in 1999, I became the President of both  
20 Sierra Pacific Power Company and Nevada Power Company. For the sixteen-year

1 period prior to 1994, I was employed by San Diego Gas & Electric Company in various  
2 positions, including Treasurer and Vice President – Finance.

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

4 **A.** In brief I will provide a financial overview of the Company and why the  
5 Company views the Energy Recovery Mechanism (ERM) as an important part of our  
6 ongoing efforts to regain solid financial health. I will also explain why the ERM  
7 “deadband” of \$9 million should be eliminated.

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

9 **A.** Yes. I am sponsoring Exhibit No. \_\_\_\_ (MKM-2), which was prepared  
10 under my direction. The exhibit will show Avista’s credit ratings by the three principal  
11 rating agencies.

12 **II. THE ERM AND THE DEADBAND**

13 **Q. Why is the Energy Recovery Mechanism (ERM) in Washington**  
14 **important to the Company?**

15 **A.** The ERM, which was implemented in mid-2002 in Washington, allows  
16 Avista to increase or decrease electric rates periodically, after obtaining WUTC  
17 approval, to reflect changes in power supply costs.

18 Similar to the PCA that is in effect for the Company in Idaho, the ERM is  
19 extremely important to the Company, its investors, its creditors and its customers as it  
20 provides an important element for improved financial stability. Variations in hydro-

1 electric conditions and volatile natural gas prices underscore the need for an effective  
2 power cost recovery mechanism. The ERM provides for a more timely recovery of  
3 power supply related costs and improves the stability of cash flow and earnings for the  
4 Company.

5 Without the ERM, the volatility of the market would be even further reflected in  
6 the volatility of the Company's earnings, the Company's cost of debt, the overall risk  
7 profile of the Company, and thus ultimately, customers' rates.

8 **Q. Why should the ERM "deadband" of \$9 million dollars be eliminated?**

9 A. Since the implementation of the ERM in mid-2002, the Company has been  
10 required to expense in excess of \$9 million dollars in each of 2003, 2004 and now 2005.  
11 (It would have been \$9 million dollars in 2002 as well except that the ERM was not  
12 implemented until July and hence the expense threshold that year was 50% of the  
13 annual target or \$4.5 million.) The power purchase expenses in excess of \$9 million are  
14 shared on a 90/10 ratio and in these same four years, the Company's 10% share has  
15 totaled \$5.7 million. Thus, the Company has absorbed over \$37 million since the  
16 inception of the ERM, through the operation of the deadband and the 90/10 sharing  
17 arrangement.

18 Moreover, natural gas costs for 2006 are projected to be in excess of the levels  
19 proformed into rates, increasing the likelihood that the Company will once again absorb  
20 some or all of the deadband. As Mr. Norwood explained in his testimony, the \$37

1 million itself, on an after-tax basis (\$24 million), represents almost 75% of total annual  
2 earnings for Avista's Washington electric operations of \$33 million.<sup>1</sup>

3 While the ERM itself is a necessary cost recovery mechanism, the \$9 million  
4 deadband undermines the Company's ability to recover its costs and thus reduce its  
5 debt, reduce its interest expenses, and return the Company to investment grade. The  
6 return to investment grade is essential, as explained in more detail later in my  
7 testimony, to lower the interest rates the Company pays for debt, and thus reduce  
8 potential rate pressure in the long term. This is especially important, given the need to  
9 finance additional capital expenditures and to replace maturing debt.

### 11 III. FINANCIAL OVERVIEW

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

13 **A.** Although the Company has made good progress in improving its financial  
14 health in recent years, Avista's credit ratings remain below investment grade and are  
15 anticipated to remain there until at least 2007. During the energy crisis of 2000 and  
16 2001, it was necessary for the Company to issue a significant amount of debt to cover  
17 electric and natural gas costs incurred by the Company, which were not yet paid for by  
18 Avista's customers. These costs were deferred, for future recovery under the accounting  
19 treatment previously approved by the Commission. These deferred electric and natural

---

<sup>1</sup> \$791 million rate base x 40% equity x 10.4% return on equity equals \$33 million.

1 gas costs exceeded \$340 million in 2001 on a system-wide basis. The electric deferrals  
2 were driven primarily by the combination of record-low hydroelectric conditions and  
3 unprecedented high wholesale market prices that occurred in 2001. Wholesale natural  
4 gas prices were also very high during the period and remained elevated to this date.

5 During this time investors and lenders were reluctant to invest in the utility  
6 industry, including Avista, and were demanding higher interest rates. Much of the debt  
7 issued by Avista during this period was at rates exceeding 9% (including \$400 million at  
8 9.75%). As a result, Avista's annual interest costs rose from approximately \$69 million  
9 in 2000 to over \$105 million in 2001 and 2002. In addition, Avista's debt ratio rose to  
10 over 59% by December 2001<sup>2</sup> and the amount of debt outstanding rose from \$715  
11 million in January 2000 to \$1,175 million by December 31, 2001.

12 These events led to significant cash requirements to pay interest on the debt and  
13 a resulting deterioration of the Company's financial condition. In October 2001, Avista  
14 Corp's senior unsecured debt and corporate rating were downgraded to below  
15 investment grade by both Standard & Poor's (S&P), and Moody's Investors Service.

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

17 **A.** We have been aggressively rebuilding our financial health by improving  
18 our cash flow, managing our costs and paying down debt. Since 2001, and through the

---

<sup>2</sup> Based on Generally Accepted Accounting Principles (GAAP) in existence in 2001.

1 fourth quarter of 2005, the Company has repurchased approximately \$319 million of  
2 higher-cost debt.

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

6 Although we are making progress in improving the Company's financial  
7 condition, we are still not as strong as we need to be, which is why the rating agencies  
8 are not yet ready to upgrade our credit rating. It is especially important for us to regain  
9 our investment grade rating in 2007 as we look toward refinancing high cost debt in  
10 2008. Typically, the rating agencies would first place us on "Positive Outlook" about  
11 one year prior to our actual upgrade. That has not yet happened.

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

14 A. The Company is continuing to rebuild its financial condition in three  
15 areas. First, we are working to assure we have adequate funds for operations, for  
16 capital expenditures and for debt maturities, through lines of credit with our banks and  
17 also by maintaining adequate access to the capital markets. We have worked with our  
18 banks to insure that we have adequate liquidity through the availability of a credit  
19 facility on the most economic basis possible. We also maintain an ongoing dialogue

1 with the rating agencies regarding the measures being taken by the Company to regain  
2 an investment grade credit rating.

3 Second, the Company is continuing to exercise high level of scrutiny with regard  
4 to operating expenses and capital investment in the operation of the business, without  
5 compromising safety and reliability.

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

12

#### 13 **IV. CREDIT RATINGS AND PLAN TO RETURN TO INVESTMENT GRADE**

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

17 A. Avista's credit ratings by the three principal rating agencies are  
18 summarized in Exhibit No. \_\_\_\_ (MKM-2). For each type of investment a potential  
19 investor could make, the investor looks at the quality of that investment in terms of the  
20 risk they are taking and the priority that they would have in the event that the



1 organization experiences severe financial stress. Investment risks include the likelihood  
2 that a company will not meet all of its obligations in terms of timeliness and amounts  
3 owed for principal and interest. Secured debt receives the highest ratings and priority  
4 for repayment and, hence, has the lowest relative risk.

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

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

12 Many of these factors are manifest in the increased earnings volatility the  
13 Company has experienced, as well as in the many credit rating downgrades by rating  
14 agencies in recent years for utilities across the country. The last several years have  
15 witnessed steady erosion in credit quality throughout the utility industry, both as a  
16 result of revised perceptions of the risks in the industry and the weakened finances of  
17 the utilities themselves.

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

19 A. Avista Utilities should operate at a level that will support a strong  
20 investment grade credit rating, meaning at least a "BBB+" or an "A-," using S&P's

1 rating scale. Financially healthy utilities are better able to invest in the needed  
2 infrastructure over time to serve their customers, and to withstand the challenges and  
3 risks facing the industry.

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

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

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

1 resulting from being below investment grade ultimately results in higher rates for our  
2 customers.

3 **Q. What are the financial ratios used by the rating agencies?**

4 The Standard & Poor's (S&P's) financial ratio benchmarks used to rate companies  
5 such as Avista are set forth below:

6 **Table 1**

<b>Standard &amp; Poor's Financial Ratio Benchmarks*</b>					
Ratio	AA	A	BBB	BB	(BB+) Avista**
Funds 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)	2.3(x)
Funds from operations/total debt (%)	35 - 45%	28 - 35%	18 - 28%	12 - 18%	9.8%
Total debt/total capital (%)	32 - 40%	40 - 48%	48 - 58%	58 - 62%	59.9%

*BBB and above = investment grade credit rating or a minimum grade rating*  
*\* Ranges for companies with a Business Profile of "6", which includes Avista Corp.*  
*\*\* As of 12/31/05*

7

8 **Q. Please describe how these ratios are calculated.**

9 A. The first ratio, "Funds from operations/interest coverage (x)", calculates  
10 the amount of cash from operations that is available to cover interest requirements. The  
11 second ratio, "Funds from operations/total debt (%)", calculates the amount of cash  
12 from operations as a percent of total debt, and the third ratio, "Total debt/total capital  
13 (%)", is the amount of debt in our total capital structure.

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

1           As shown in Table 1 above, as of December 31, 2005 Avista falls within the BB  
2 range for two of the three ratios and actually falls below BB for “funds available as of %  
3 of total debt.”

4           For the first ratio, “funds from operations/interest coverage”, Avista’s result is  
5 2.3x which is well below the 3.0-4.2 range needed to qualify for a BBB rating. As  
6 discussed previously, progress in increasing this ratio to meet the investment grade  
7 level has been slower than anticipated due to reduced stream flows affecting hydro  
8 generation, higher thermal fuel costs than what we are currently recovering in rates,  
9 and higher capital expenditures that require cash up front before we can recover the  
10 costs from customers. Each has an impact on the Company by reducing the amount of  
11 available cash flow from operations, requiring external financing which ultimately  
12 result in higher debt and lower interest coverage ratios.

13           Avista’s position as of December 31, 2005, for the second ratio, “funds from  
14 operations/total debt” is 9.8% compared to the 18%-28% needed for investment grade - -  
15 well below what is required. In fact, Avista’s ratio in this category does not even fall  
16 within the BB range.

17           Avista’s rating as of December 31, 2005, for the third ratio, “total debt/total  
18 capital” is 59.9% compared to 48-58% needed for investment grade. In order to move  
19 all three ratios’ within the required range to meet investment grade requirements,  
20 Avista must reduce its total debt balances and increase its available funds from

1 operations. Although the Company has continued to work towards paying down its  
2 total debt, the negative impacts to cash flow caused by below-normal hydroelectric  
3 generation and the variability of natural gas prices, adversely affect Avista's ability to  
4 reduce total debt.

5 **Q. Do the rating agencies look at any other factors when evaluating a**  
6 **company's credit quality?**

7 A. Yes, they do. The rating agencies evaluate the company's resource  
8 picture, the competitive environment in which we operate, the regulatory environment  
9 including the timely recovery and certainty of recovery of costs, quality of management  
10 and financial policy. Therefore, while the ratios are utilized in their quantitative  
11 evaluation of a company, they are not the only factors that are taken into account.

12 **Q. How important is the regulatory environment in which a Company**  
13 **operates?**

14 A. According to my discussions with the rating agencies, the regulatory  
15 environment in which a company operates is a major factor in determining a company's  
16 creditworthiness. As explained earlier by Ms. Cannell, given investors' heightened  
17 awareness of the risks associated with the electric power industry and the damage that  
18 results when a utility's financial flexibility is compromised, supportive regulation is  
19 perhaps more crucial now than at any time in the past.

20

1                   **V. CAPITAL REQUIREMENTS AND THE REFINANCING OF DEBT**

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 2006-2007 is approximately \$330  
8 million. For 2006 alone, these costs are projected to total \$170 million. A few of the  
9 major capital expenditure items include \$25 million for transmission and distribution  
10 upgrades, \$41 million for electric and natural gas customer growth, \$10 million for  
11 environmental affairs (associated with the Spokane River relicensing and the 2001 Clark  
12 Fork River license implementation issues), and \$23 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  
18 interest coverage, and investment grade credit ratings to be able to access capital at  
19 reasonable costs.

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



1 agreements secured a fixed rate for a significant portion of the total interest that will be  
2 paid on this portion of the debt that will be refinanced in 2007 and 2008. By entering  
3 into swaps totaling \$200 million, we have locked in a significant amount of interest rate  
4 certainty for almost 40% of the debt that must be refinanced.

5 **Q. What other financing activities did the Company complete in 2004-2005**  
6 **that will lower its interest costs?**

7 A. The Company refinanced \$60 million of 7.875% Trust Preferred Stock in  
8 April 2004. For the next five years, the interest rate will be 6.50%, which results in  
9 approximately \$750,000 in annual savings. These savings were reflected in the  
10 Company's recent general rate case.

11 During 2005 the Company purchased an additional \$26 million in higher priced  
12 Medium Term Notes and \$28 million matured. In addition, in the 4<sup>th</sup> quarter of 2005,  
13 the Company issued \$150 million of 30-year First Mortgage Bonds at 6.25%. The  
14 Company's annual interest expense for 2005 was \$92.7 million.

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

16 A. In 2002, we had to secure our credit line with First Mortgage Bonds  
17 whereby the banks now have the same ranking in priority as Avista's other First  
18 Mortgage Bond holders. While our financial condition has improved, the banks  
19 continue to require the safety of a line secured by our utility property. The facility  
20 needs to be large enough to allow the Company to fund at least one year of capital



1 expenditures, plus required working capital and counterparty collateral requirements to  
2 assure flexibility, given both the volatile financial markets and the volatile energy  
3 commodity prices.

4 Many purchases of natural gas, or contracts for pipeline capacity to provide  
5 natural gas transportation, have required collateral, or prepayments, given the  
6 Company's credit rating. The line of credit is our only source of immediate cash for  
7 borrowing to meet these needs and for supporting the use of letters of credit. We need  
8 a line of credit just to manage daily cash flow since the timing of cash receipts versus  
9 cash disbursements is never totally balanced.

10 In May 2004, the Company's line of credit was amended to increase the available  
11 amount from \$245 million to \$350 million and the expiration date was extended to May  
12 2005. The credit line was increased to accommodate possible increases in liquidity  
13 requirements and the potential for consolidations within the banking industry. In  
14 December 2004, the Company renegotiated its \$350 million corporate line of credit,  
15 lowering the borrowing costs (providing over \$1 million of interest savings annually)  
16 and extended the term to five years, now expiring in December 2009. The agreement  
17 also now includes the option to release the first mortgage bond security if the Company  
18 regains its investment grade credit rating. This demonstrates recognition by our banks  
19 that Avista's financial condition is improving.

1           **Q.    What are Avista’s plans regarding common equity and why is this**  
2 **important?**

3           A.    Avista needs to improve the common equity ratio of its capital structure.  
4    The Company is accomplishing this by continuing to reduce debt, as well as by  
5    improving retained earnings. It is important to the rating agencies who influence the  
6    Company’s cost of debt, and hence an important component of the Company’s cost of  
7    doing business, for Avista to have a more balanced debt/equity ratio in order to  
8    minimize the risk of default on required debt interest payments. This is due to the fact  
9    that dividends on most equity are not contractual until the Company’s Board makes a  
10   quarterly declaration. In addition, debt holders want to see a higher percentage of  
11   equity investment by the Company’s owners so as to minimize their risk not only on the  
12   interest payments but on receiving repayment of their principal as well.

13           The more flexibility the Company has by maintaining access to both the debt and  
14   equity markets, the stronger our financial condition will become. The opportunity to  
15   earn our allowed return on equity will continue to build the equity ratio, and improve  
16   the Company’s financial condition. It is also important to have a higher common equity  
17   ratio in the event adverse conditions develop.

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

19           A.    Yes.