Exhibit No.___(MPG-1T)
Docket No. UE-060181
Witness: Michael Gorman

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of AVISTA CORPORATION, d/b/a AVISTA UTILITIES, For Continuation of the Company's Energy Recovery Mechanism, with Certain Modifications.	)	**Docket No. UE-060181**

DIRECT TESTIMONY OF

MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

April 21, 2006

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a principal in the firm of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exhibit No.___(MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I will respond to Avista's (or the "Company") application and supporting testimony to modify its Energy Recovery Mechanism ("ERM").

Q. PLEASE DESCRIBE AVISTA'S PROPOSED MODIFICATION TO ITS ERM.

A. Avista proposes two principal changes to its ERM. First, it proposes to eliminate the "deadband" feature of the ERM. Second, Avista proposes to include certain transmission revenue and expenses components in the ERM calculations. ICNU witness Randy Falkenberg will responds to this proposal.

I. SUMMARY OF RECOMMENDATIONS

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN THIS PROCEEDING.

A. I recommend the Company's proposed changes to the ERM be rejected in this proceeding. As set forth in Mr. Falkenberg's testimony, ICNU proposes an alternative ERM deadband methodology and sharing mechanism that is more consistent with the power cost adjustment mechanisms ("PCA") of other Northwest utilities. I will respond to the credit strength and credit risk associated with ICNU's proposal.

The Commission should reject most of the Company's arguments for the following reasons.

- Avista's current credit distress is largely tied to its unrecovered deferred purchased power costs incurred during the Western power crisis, as well as underperforming operations of unregulated operations. Avista's proposal does not address this important problem. Pursuant to Avista's last rate settlement, customers are required to pay rates that produce revenues that are significantly in excess of Avista's current cost of service and provide significant annual funding to Avista to help accelerate the pay down of the debt to support this deferred power cost asset. This debt pay down is key to improving Avista's current credit strength. Hence, customers are already making significant contributions, above the normal obligation, to compensate Avista for its cost of service. This extraordinary customer commitment is designed to improve Avista's current credit standing.

- Eliminating the ERM deadband certainly would reduce its investor risk, but at the expense of increasing its customer operating risk. Hence, the relevant issue here is whether the proposed shift of risk from investors to customers is just and reasonable. As described in detail below, Avista's proposal does not strike an appropriate balance between investors and customers. If the Commission does modify Avista's ERM by reducing or eliminating the deadband, it should do so only with conditions that attempt to moderate rate volatility to customers, and recognize customers' significant contributions to Avista's efforts to accelerate the pay down of debt and improve its financial standing.

Q. PLEASE SUMMARIZE THE CONDITIONS THE COMMISSION SHOULD IMPLEMENT IF IT MODIFIES AVISTA'S ERM BY REDUCING OR ELIMINATING THE DEADBAND.

A. If the Commission modifies Avista's ERM by reducing or eliminating the deadband, I recommend it do so only with the following conditions included as part of the ERM:

- First, if the Commission approves an adjustment to the ERM calculation, which passes most or all of the purchased power and fuel cost risk to customers, then the Commission should also adopt new provisions that mitigate rate volatility for customers. Hence, any adjustment to the ERM methodology in this case should also include an earnings test which ensures that no costs are deferred at a time when the Company is already earning its authorized rate of return on utility operations and that the Company is not required to credit cost savings to the ERM deferral account if earnings are inadequate. The ERM focuses only on selected costs for the utility. To the extent other costs decrease or reserves increase, which offsets excess power cost increases, it is possible that Avista will earn its authorized return on equity even if it has to absorb some or all the excess power costs not recovered in base rates. Customers should not be asked to pay higher rates if Avista's rates already provide adequate revenue to provide it with an opportunity to earn the Commission authorized rate of return on utility plant investments.

- A significant credit rating improvement objective for Avista is to pay down debt, and an important rate objective for customers is to conclude the surcharge directed at the recovery of deferred power costs. The Commission should require Avista to exercise every opportunity available to it to reduce this deferral balance, and thus eliminate the surcharge rate. This can be accomplished by recognizing significant decreases in Avista's cost of debt, compared to that built into current rates, and using all savings as additional accelerated amortizations of the deferred power cost balance until Avista's next base rate filing. Avista's settlement rates were based on an embedded debt cost of 8.44%. Avista readily acknowledges that it will refinance significant amounts of debt during calendar years 2007 and 2008. As Avista refinances its embedded cost of debt, its debt interest expense will meaningfully decline, relative to the debt interest expense built into base rates. This debt interest savings should be recorded in a deferred account and used to accelerate the amortization of deferred power costs.

- The third condition of the modified ERM should be the investigation and implementation of a prudent hedging strategy that targets stabilizing the Company's rates as well as attempting to procure purchased power and fuel in a reasonable and prudent manner. Avista should be required to demonstrate that it has implemented a prudent hedging strategy as a follow-up to any modification of the ERM deadband.

II. OVERVIEW OF AVISTA'S FILING

Q. HOW DOES AVISTA SUPPORT THE CONCEPT OF AN ERM MECHANISM?

A. Avista witness Malyn K. Malquist states that the current ERM was implemented in mid-2002 in Washington, and allows Avista to increase or decrease electric rates periodically, after obtaining WUTC approval, to reflect changes in power supply cost.[1/]

[1/] Exh. No.___(MKM-1T) at 2.

Mr. Malquist asserts that the ERM is extremely important to the Company, its investors and creditors, and its customers as it provides an important element to improve financial stability. He asserts the variation in hydroelectric conditions and volatile natural gas prices underscore a need for an effective power cost recovery mechanism. He also asserts that the ERM provides for a more timely recovery of power supply costs and improves Avista's stability of cash flow and earnings. He opines that without the ERM, volatility in the wholesale market would increase the Company's earnings volatility, its cost of debt and overall risk profile, and ultimately would increase rates to customers.[2/]

Q. WHY DOES AVISTA PROPOSE TO ELIMINATE THE ERM DEADBAND?

A. The Company maintains that the current ERM mechanism has resulted in over $37 million of cost under-recovery over the period July 2002, through the end of 2005. Mr. Malquist asserts that this cost under-recovery is eroding the Company's credit standing and impacting its cost of funding capital expenditures and refinancing significant amounts of debt in calendar years 2007 and 2008. Mr. Malquist asserts that elimination of the ERM deadband will improve Avista's earnings and cash flow stability, and thus improve its credit standing. This in turn will allow Avista to meet its debt refinancing and capital expenditure requirements at a lower cost of debt.

Further, Avista witness Julie M. Cannell asserts that the current ERM deadband of $9 million subjects the Company to earnings and cash flow volatility, which makes it difficult for investors to predict Avista's futures earnings and cash flow growth. She concludes that investors believe that the deadband features of the current ERM will limit

[2/] Id. at 2-3.

Avista's ability to recover its investment grade bond rating and will increase its investment risk.

Q. DID MR. MALQUIST ALSO PROVIDE A FINANCIAL OVERVIEW OF AVISTA IN HIS TESTIMONY?

A. Yes. At pages 4 to 6 of his testimony, Mr. Malquist provides an overview of Avista's financial situation since the high power prices during the energy crisis in 2000 and 2001. Mr. Malquist alleges the following points:

- In calendar years 2000 and 2001, Avista issued significant amounts of debt to fund electric and natural gas costs that were incurred by the Company, but were not yet paid by Avista customers.
- These power costs were deferred for future recovery under an accounting treatment approved by the Commission.
- These deferred power costs exceeded $340 million in 2001 on a system-wide basis.
- The power cost deferrals were driven primarily by the combination of record low hydroelectric conditions and unprecedented high wholesale power prices that occurred in 2001. Wholesale natural gas prices were high during 2001 and have remained elevated.
- During that time period, investors demanded high interest rates for investing in Avista compared with other utility companies. Much of the debt issued by Avista during that time period had interest rates that exceeded 9%, including $400 million issued at an interest rate of 9.75%. As a result, Avista's annual interest cost increased from $69 million in 2000, to over $105 million in 2001 and 2002. As such, Avista's debt ratio rose to over 59% by the end of 2001, and its amount of debt increased from $715 million in January 2000 to $1.175 billion by the end of 2001.
- In October 2001, Avista's senior unsecured debt and corporate credit ratings were downgraded to below investment grade by both Standard & Poor's ("S&P") and Moody's investor service.
- More recently, Avista has repurchased approximately $319 million of its high cost debt, thus reducing its debt interest cost.
- In December 2002, S&P affirmed its credit ratings for Avista and upgraded its credit outlook to stable from negative.

Q. DID MR. MALQUIST ALSO IDENTIFY STEPS THE COMPANY HAS UNDERTAKEN TO IMPROVE ITS FINANCIAL HEALTH?

A. Yes. Mr. Malquist identified three steps. First, he states the Company is working to maintain adequate funds from operations for capital expenditures and for debt maturities through lines of credit and by maintaining access to external capital markets. Second, the Company has continued to exercise a high level of scrutiny regarding operating expenses and capital investments without compromising safety and reliability. Third, he states that the Company is working through regulatory processes to recover its cost so that its earned returns are closer to those allowed by regulators in each of the states it serves.[3/]

Q. DOES AVISTA CLAIM THAT ITS PROPOSAL TO ELIMINATE THE DEADBAND IN ITS ERM IS IMPORTANT IN ACHIEVING ITS CREDIT RATING IMPROVEMENT TARGETS?

A. Yes. Mr. Malquist asserts that the volatility of the wholesale power markets and gas prices are of concern to equity and credit analysts and Avista's ability to shed this risk via modified regulatory mechanisms will be positively received by the capital markets.[4/]

Q. HAS AVISTA MADE A CONVINCING CASE FOR ELIMINATION OF THE DEADBAND?

A. No. Avista has failed to show that elimination of the deadband results in a fair allocation of risks between shareholders and customers. In addition, Avista's analysis of financial metrics is based on assumptions that are stale and not reflective of Avista's going forward cost of debt and cash coverage of debt obligations. The rate increase granted in Avista's last general rate case, combined with its ability to retire expensive debt at lower costs, will provide Avista with an adequate opportunity to improve its credit rating, without eliminating the deadband.

[3/] Id. at 6 and 7.
[4/] Id. at 12.

III. ACCESS TO CAPITAL

Q. SHOULD THE COMMISSION CONSIDER ONLY THE IMPACT ON AVISTA, ITS INVESTORS AND CREDITORS IN ASSESSING THE REASONABLENESS OF ITS PROPOSAL TO ELIMINATE THE ERM DEADBAND?

A. No. By eliminating the ERM deadband, Avista is not eliminating wholesale market and natural gas price risk, but rather, it is transferring this risk to its customers. Importantly, Avista's customers also must attract capital in order to make investments in non-regulated businesses in the State of Washington. To the extent the Commission implements regulatory mechanisms that increase utility rate volatility, customers of Avista and other Washington utilities may experience significant fluctuations in operating expenses caused by volatile utility rates, which could erode their earnings and cash flow and impair their ability to attract capital to fund needed business investments to maintain and expand operations in the State of Washington.

Hence, a balanced regulatory mechanism that considers the risk impacts on both Avista and its customers is of paramount importance in properly designing an ERM, which balances the interests of both investors and ratepayers. As the Commission recently noted in rejecting PacifiCorp's PCAM, "power cost recovery mechanisms should also apportion risk equitably between ratepayers and shareholders."[5/] Likewise, in its final order in the last Avista rate case, the Commission stated that one purpose of this proceeding is to determine whether changes to the ERM will result "in a more effective balance of risks than is currently in place."[6/]

5/ WUTC v. PacifiCorp, WUTC Docket No. UE-050684, Order No. 4 at ¶ 96 (Apr. 17, 2006).
6/ Docket No. UE-050482, Order No. 5 at ¶ 73.

Q. DID AVISTA CONSIDER THE IMPACT ON ITS CUSTOMERS' ABILITY TO ATTRACT CAPITAL IN FORMULATING ITS PROPOSAL TO ELIMINATE THE ERM DEADBAND?

A. No. Avista witness Julie Cannell acknowledged that Avista's proposal would have an impact on customers, but Ms. Cannell failed to assess the impact. Her testimony was directed at reviewing the investor implications on Avista from eliminating the ERM deadband. She did not review the consequential impact on Avista's customers and their ability to attract capital.[7/]

Q. DID MR. MALQUIST ALSO PROVIDE S&P CREDIT RATING FINANCIAL METRICS IN SUPPORT OF HIS CONTENTION THAT AVISTA'S CURRENT CREDIT RATING IS NOT CONSISTENT WITH AN INVESTMENT GRADE UTILITY?

A. Yes. Mr. Malquist calculated S&P's credit rating financial metrics for Avista, and compared those to S&P's benchmarks for a BBB rated investment grade utility company, and a BB below investment grade utility company. Ratios calculated for Avista were then compared to S&P benchmarks. As noted by Mr. Malquist on pages 10-11 of his testimony, Avista's current ratios are not consistent with an investment grade bond rating.

Q. PLEASE BRIEFLY DESCRIBE S&P'S FINANCIAL CREDIT RATIO BENCHMARKS AND HOW THEY ARE APPLIED TO UTILITY COMPANIES.

A. S&P publishes a matrix of financial ratios that are used as guidelines in assessing the overall credit quality of regulated utility operations. An integral step in S&P's financial metric calculations is an assessment of a utility's overall business risk. S&P opines that a company that has low business risk can assume greater financial risk and still maintain investment grade credit quality. Conversely, a utility that has a higher business risk must

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[7/] Exh. No.___(MPG-3).

reduce its financial risk in order to maintain investment grade credit standing. Hence, a utility's credit rating is a function of both financial and business risk.

S&P publishes financial benchmark targets based on a utility's business profile score. S&P business profile scores range from 1 (lowest risk) to 10 (highest risk). Most integrated utility companies have business profile scores between 4 and 6.

Q. DO YOU HAVE ANY GENERAL COMMENTS CONCERNING MR. MALQUIST'S COMPARISON OF AVISTA'S CREDIT METRICS TO THOSE OF S&P'S BENCHMARKS?

A. Yes. There are at least three relevant issues the Commission should consider in assessing Mr. Malquist's comparison of Avista's credit metrics with the S&P benchmarks. First, of particular importance is Avista's current business profile score from S&P of 6. Other utilities in the Pacific Northwest have lower risk profile scores; for example, PacifiCorp and Puget Sound Energy have business profile scores of 5 and 4, respectively.[8] Importantly, PacifiCorp does not have an ERM mechanism in Washington, Oregon or Utah. It has recently been awarded such a mechanism in Wyoming; however, the Wyoming mechanism includes "a deadband of $40 million above and below the base, as well as three significant sharing bands." Puget Sound Energy has a power cost recovery mechanism that includes a $20 million deadband, as well as a sharing mechanism.[9] Accordingly, the improvement in Avista's business profile score from S&P would likely not be tied to any significant modification of the ERM deadband mechanism.

Second, Avista's business risk is perceived as greater than that of other Northwest utilities. It is not clear why S&P assigns more business risk to Avista than it does to other utilities that operate in the state of Washington. However, it is likely attributable to

[8] S&P's U.S. Utility and Power Ranking Risk, March 24, 2006.
[9] Docket No. UE-050684, Order No. 4 at ¶ 95.

Avista's long affiliation with higher risk, unregulated operations. For example, Avista Corporation principal unregulated subsidiary reported a net after tax loss of $8.6 million for 2005.[10/] These operating losses increase business risk and thus raise the bar for Avista to regain its investment grade bond rating. In any event, Avista must meet more stringent financial ratio coverages than PacifiCorp and Puget Sound Energy, in order to achieve an investment grade bond rating. Avista's ability to achieve an investment grade bond rating would be enhanced if its business profile score from S&P is lowered to be in line with other Northwest utilities. It may be able to accomplish this by isolating its utility operations from its higher risk non-regulated utility operations. Avista currently is seeking to form a holding company. If it implements ring-fence utility protections or financially isolates its utility operations in this restructuring from higher risk non-regulated operations, it may be possible for Avista Utilities to lower its business profile score and thus lower the financial thresholds needed to improve its credit rating to investment grade.

Third, Mr. Malquist calculated the ratios as of December 31, 2005. These ratios are significantly impacted by the very high cost debt Avista had to issue in calendar year 2001 to finance its deferred purchased power cost, which it has not yet retired or refinanced. As Mr. Malquist noted, the Company had to issue significant amounts of debt at interest rates exceeding 9% in the 2001-02 time frame to finance deferred power costs. The Company has taken financial positions that will allow it to refinance 40% of this debt in 2007 and 2008 at much lower interest rates. Indeed, an Avista data response

10/ Avista Corporation 2005 10K at 23.

indicates that approximately 40% of the debt will be financed at interest rates of less than 6% rather than interest rates that exceed 9% and average approximately 7.5%.[11/]

Accordingly, Mr. Malquist's review of Avista's credit metrics for end of year 2005 simply does not reflect Avista's interest rate financial positions that will significantly lower its future cost of debt and improve its credit rating financial metrics.

Q. DOES THE RATE SETTLEMENT PREVIOUSLY APPROVED BY THE COMMISSION IN AVISTA'S MOST RECENT RATE CASE SUPPORT IMPROVEMENT IN AVISTA'S CREDIT RATING?

A. Yes. The most significant factor that will help Avista improve its credit rating is to pay down expensive debt and restructure its capital structure to be more in line with low risk regulated utility operations. The primary factor in achieving that objective is to reduce the debt that is currently supporting the significant balance of deferred purchased power costs. The rate settlement approved by the Commission already provides significant customer contributions to Avista to help it achieve this objective. These customer contributions include the following:

- The use of a hypothetical capital structure composed of a 40% common equity ratio and a 10.4% return on equity. The hypothetical common equity ratio is significantly higher than Avista's actual 27% utility common equity ratio. Setting rates based on a hypothetical capital structure provides Avista with an opportunity to earn a 12.9% return on its utility equity capital.[12/] This return opportunity is much greater than the 10.4% included in the rate settlement.

- The 12.9% return opportunity on utility equity is significantly higher than authorized returns on equity for other utilities throughout the nation. Indeed, over the last two years, authorized returns on equity have averaged less than 10.5%, and long-term capital market costs have continued to decline.[13/] Hence, the earnings opportunity provided to Avista in the rate settlement provides a significant premium to contemporaneous authorized returns on equity, which will enhance Avista's internal cash flow and earnings and provide additional internal funding to allow it to pay down debt.

11/ Exh. No.___(MPG-4).
12/ Exh. No.___(MPG-5).
13/ The Commission recently adopted a return on equity of 10.2% for PacifiCorp.

- The rate settlement also provided for a 10% increase in the ERM surcharge tariff for the purpose of reducing the deferred power cost balance more rapidly than would otherwise have been the case. This increased customer rates by approximately $2.7 million per year. The increase to the surcharge tariff enhances Avista's cash flow available to reduce outstanding debt and improve its credit rating.

- Avista's revenue requirement was increased by approximately $12.7 million, due to a combination of the hypothetical capital structure and increased surcharges above its cost of service.[14/] This increased cash flow will make a meaningful contribution to the funds available to reduce Avista's outstanding debt supporting its deferred power cost. This debt reduction will in turn improve Avista's credit rating financial metrics, allow it to reduce its outstanding debt interest cost, and help support an improvement to its bond rating.

Avista's proposal to shift additional purchased power and gas cost recovery risk to customers by elimination of the ERM deadband is unreasonable in light of the significant revenue contributions customers are already providing to assist Avista to reduce its debt and improve its credit rating.

Q. DOES THE CURRENT ERM DEADBAND OF $9 MILLION, BY ITSELF, CAUSE SIGNIFICANT CREDIT EROSION AT AVISTA?

A. No. The ERM deadband works in a symmetrical fashion. It can provide Avista with an opportunity to over-earn its authorized return on equity and strengthen its credit metrics, as well as assume the risk that it will under-recover its ERM costs and decrease its credit metrics and earned return on equity. Since creditors and investors are concerned with the risk of under-recovering the ERM costs, I will assess the potential impact on Avista's credit rating financial metrics if it should under-recover its ERM costs.

The ERM does cause material fluctuation in Avista's earnings when ERM costs are over or under-recovered by $9 million. However, $9 million pre-tax in any single year will not cause a significant impact to the Company's credit rating financial metrics.

14/ Exh. No.___(MPG-6).

The problem, if any, with the current ERM has not been the design of the ERM mechanism, but rather the abnormal circumstances the Company has experienced over the last three and one-half years related to sustained abnormally low hydro conditions, which caused Avista to purchase or generate more expensive replacement energy. Hence, under more normal hydro conditions, the current ERM mechanism does not expose the Company to excessive credit risk. Also, as noted by Mr. Falkenberg, under the original ERM stipulation, it was expected that Avista would underrecover its power costs at least through 2004, due to certain out-of-market gas contracts it had executed.[15/]

Q. PLEASE DESCRIBE THE IMPACT ON THE COMPANY'S CREDIT RATING FINANCIAL METRICS IF IT UNDER-RECOVERS ITS ERM COSTS BY $9 MILLION IN ANY GIVEN YEAR.

A. As shown on the attached Exhibit No. (MPG-7) and Exhibit No. __ (MPG-8), I have calculated the Company's credit metrics under full recovery of ERM costs, and a $9 million under-recovery of ERM costs. These credit ratio calculations are based on the revenue requirement developed in the Company's most recent revenue requirement settlement, with and without an under-recovery of ERM costs. Also, for purposes of this calculation, I used an embedded debt cost rate of 7%, rather than the 8.44% used to develop Avista's revenue requirement in its last rate proceeding, since the Company has taken financial positions that have locked in interest rates for 40% of the debt that will mature in 2007 and 2008.[16/] Hence, I believe it is reasonable to review credit rating financial metric calculations with a lower embedded debt cost that is more in line with other utility companies, and a better reflection of Avista's going forward debt cost.

15/ Exh. No.___(RJF-1T) at 5-6.

16/ Exh. No.___(MPG-4).

Albeit, a 7% embedded interest rate still represents an above-average embedded cost of debt for regulated utility operations.

As shown below in Table 1, I have summarized the results of this credit metric analysis. I calculated Avista's funds from operations ("FFO"), interest coverage ratio and FFO to total debt, and compared Avista's ratios to S&P's credit rating financial metric calculations for a utility company with an investment grade bond rating of BBB, and a rating of BB, both at a business profile score of 6, Avista's current profile score.

As shown below in Table 1, the under-recovery of $9 million of ERM costs will cause Avista's FFO to interest coverage ratio to drop from 3.3x to 3.1x. The FFO/Interest ratios support an investment grade bond rating with and without full ERM cost recovery.

Also, the FFO to debt ratio with and without fully recovering the ERM costs decreases from 16.0% to 15.0%. Both ratios are below the investment grade bond rating range.

I did not calculate differences in total debt to total capital ratios, which is another primary ratio that S&P considers in the credit review of a utility company, because this debt ratio would not be significantly impacted by the under-recovery of the ERM costs in a single year.

TABLE 1

S&P Credit Rating Financial Ratios

Description	Full ERM Cost Recovery	Under Recovery ERM by $9 Million	BBB Range*	BB Range*
FFO/Interest	3.3x	3.1x	4.2x – 3.0x	3.0x – 2.0x
FFO/Debt	16.0%	15.0%	28.0% - 18.0%	18.0% - 12.0%
Return on Equity	10.4%	8.7%	---	---

* Profile score of 6.
Source: Attached Exhibits No.___(MPG-7) and No.___(MPG-8).

Q. WHAT CONCLUSIONS DO YOU DRAW FROM YOUR CREDIT RATING FINANCIAL RATIO CALCULATIONS?

A. First, as noted above, and as implicit in Mr. Malquist's testimony, improvement to Avista's bond rating from below investment grade to above investment grade is highly dependent on debt reduction. Focusing on deferred power cost recovery can provide funding to pay down Avista's debt and reduce its debt interest expense. This will improve Avista's credit rating financial ratios and likely its credit rating. Also, customers will benefit through the accelerated pay down of deferred power costs, because the rates they pay will be reduced after these deferred power costs are fully recovered.

Second, under-recovery of ERM costs of $9 million will reduce the Company's funds from operations by approximately $5.6 million, or approximately 7.5% of the FFO generation of $73.69 million implicit in the Company's settlement revenue requirement. Of course, the mechanisms of the ERM allow for an increase in FFO coverage by roughly the same percentage. While this FFO variability is certainly not insignificant, it is not the primary issue that is preventing Avista from achieving investment grade bond rating as noted above. Again, the primary issue restricting Avista from achieving its investment grade status is recovery of the deferred power balance, not the annual workings of the ERM and its deadband. Thus, the Commission should adopt a mechanism that appropriately balances ratepayer and shareholder interests over time, rather than one designed to remedy the one-time situation created by power costs deferred during the energy crisis.

Q. HAS AVISTA'S BELOW INVESTMENT GRADE UNSECURED BOND RATING BEEN ENTIRELY THE RESULT OF ITS UNRECOVERED POWER COSTS DUE TO THE WESTERN POWER CRISIS AND DEFERRALS RELATED TO THE ERM COST UNDER-RECOVERIES?

A. No. Avista's credit rating has been significantly negatively impacted by its investments in unregulated businesses and the failure of those investments to contribute adequate coverage of debt obligations. Further, these unregulated investments represent much higher operating risks than do regulated utility operations, therefore increasing the Company's operating risk characteristics. As a point of reference, I have attached as Exhibit No.___(MPG-9) the testimony of John S. Thornton, Jr., that provides a reasonable and accurate assessment of Avista's credit rating history over the period 1998 through mid-year 2001.[17/] This is a period where Avista's credit rating was decreased from a relatively strong utility rating, down to minimum investment grade. Avista's unsecured bond rating was later downgraded to below investment grade in response to wholesale market extreme conditions that took place in the Western power markets. Since Avista's credit problems are due in part to activities designed to benefit

[17/] Mr. Thornton's testimony was admitted as Exhibit 604 in Re Avista Corporation, WUTC Docket No. UE-010395.

shareholders, not ratepayers, any measures aimed at improving Avista's credit, including changes to the ERM, should include an appropriate contribution from shareholders.

IV. BALANCED INTEREST OBJECTIVES

Q. DO YOU RECOMMEND THAT THE COMMISSION CONSIDER ANY IMPORTANT OBJECTIVES IN MODIFYING AVISTA'S ERM TO BALANCE THE INTEREST BETWEEN CUSTOMERS AND SHAREHOLDERS?

A. Yes. As outlined in the Company's testimony, volatility in power costs and natural gas cost is very real in today's marketplace. This volatility can be managed to a certain degree by Avista by implementing hedging transactions that allow it to lock in fuel and power costs at prices that can be fully covered through base rates. To the extent the company is not able to lock in power and fuel prices that can be fully recovered by base rates, the Company is free to file for base rate changes as a further option to protect earnings and cash flow. Hence, the Company is able to manage, to some degree, wholesale power and gas cost volatility through a combination of financial hedging transactions, firm supply contracts, and regulatory filings.

In significant contrast, customers are not able to implement the same types of hedging strategies to protect their operations from the volatile wholesale power market. Specifically, customers are not involved in Avista's procurement decision making, and customers cannot lock in firm supply contracts or take financial positions that will protect utility prices from volatile wholesale market conditions. Hence, customers would be fully exposed to wholesale power and gas price volatility if these costs are passed through an ERM without reasonable hedging protections.

As such, in developing a balanced regulatory ERM mechanism, the Commission should give careful consideration to the stakeholder that is best able to manage the wholesale price risk. In this case, Avista is much more able to manage the risk of volatile wholesale power and gas prices than are its retail customers. Hence, Avista should be allocated a reasonable portion of this risk so it will take reasonable steps to manage this risk on behalf of its investors and its customers. Relieving Avista from wholesale power and natural gas risk could create significant pricing distress on retail customers simply because Avista would have no economic incentive to manage the price risk.

A second issue the Commission should consider is that if the ERM is modified in such a way that Avista's risk is materially reduced, this risk reduction should be reflected in a reduced cost of capital for Avista. The Commission explicitly recognized this requirement in its recent PacifiCorp Order.[18/] Since Avista's last rate settlement was based on a rate of return more reflective of Avista's risk under the current ERM mechanism, the Commission should carefully consider the need to reduce base rates in response to any modification to the ERM mechanism that reduces the Company's risk. In addition, any change to the ERM mechanism that materially changes the balance of risks arguably should be made only in a general rate case.

Q. IF THE COMMISSION ELIMINATES OR REDUCES THE DEADBAND OF THE CURRENT ERM, SHOULD IT ALSO IMPLEMENT OTHER MEASURES TO MITIGATE THE POTENTIAL RATE VOLATILITY PLACED ON RETAIL CUSTOMERS?

A. Yes. In order to mitigate potential wholesale price volatility risks that will be transferred to customers, the Commission should, at a minimum, implement the following additional requirements in modifying the deadband provisions of Avista's current ERM:

1. The Commission should require an earnings test before Avista is allowed to defer any increases or decreases in power costs to the ERM deferral account.. Avista states that it proposes to eliminate the deadband because doing so will improve the probability that it will be able to <u>earn its authorized return on equity</u>, which

[18/] WUTC Docket No. UE-050684, Order No. 4 at ¶91.

will be viewed positively by credit analysts.[19/] Accordingly, consistent with this objective, if the Company is already earning a return on equity within 100 basis points of its authorized return on equity, then it need not defer costs if it is under-recovering power costs. An earnings test will allow for a full review of all of the Company's revenues and expenses to judge whether sales increases or other cost decreases are offsetting its increased power costs. If the earning test shows that no increase in rates is necessary, then the Company will have fully recovered its power costs and achieved its objective of earning a return near its authorized return on equity. Likewise, if the Company is under earning, it should not be required to credit power cost savings to customers.

2. The Commission should require Avista to demonstrate that it has implemented an appropriate hedging strategy in order to protect customers from the potential rate volatility created by the pass through of volatile wholesale power market prices and gas costs. While wholesale market price volatility has certainly increased in the past, so too have extreme price periods in the marketplace caused by many factors, including hurricanes, major plant outages and market manipulations. Prudent hedging strategies can help protect customers from extreme market pricing conditions brought about by extreme events.

3. Finally, as noted above, Avista's last rate settlement already included significant customer contributions to Avista's cost of service to help accelerate the pay down of debt and provide assistance in achieving its financial integrity improvement objectives. Any modification to the ERM, which shifts commodity risks to customers and away from Avista, will create further burdens on Avista's customers who are already assuming greater burdens than that which the Commission has traditionally asked utility customers to bear (that is, paying more than the Company's actual cost of providing service). To recognize this disproportionate allocation of burden to retail customers, the Commission should use every opportunity for cost reductions at Avista to be reflected as an additional accelerated pay down of Avista's deferred power costs. Expected cost reductions that should be deferred and used to accelerate the pay down of Avista's deferred power costs include debt refinancings expected in 2007 and 2008, significant expected reductions to Avista's debt interest expense, and failure to achieve equity building targets prior to the implementation of rate reductions as set forth in the stipulation agreement.

[19/] Exh. No.___(MGM-1T) at 7.

Q. DO YOU HAVE ANY CONCERNS ABOUT AVISTA'S COMMITMENT TO MEETING THE EQUITY BUILDING BENCHMARKS AND DEBT REDUCTION GOALS IMPLICIT IN THE SETTLEMENT THAT THE COMMISSION SHOULD CONSIDER WHEN EVALUATING ITS PROPOSAL TO MODIFY ITS ERM IN THIS PROCEEDING?

A. As noted above, the settlement rates provide Avista with significant revenue above its cost of service as additional ratepayer contributions to help it meet its debt reduction goals, strengthen its capital structure and improve its credit rating. As part of that rate settlement, Avista agreed to target debt reduction in a way that would build equity and achieve certain equity ratio targets. ICNU argued that the Commission should impose more stringent requirements, including restricting dividends and requiring that the increase in revenue requirement be dedicated to paying down the deferred power cost balance. The Commission rejected these proposals.[20/]

Certain decisions by management may be at odds with Avista's commitments in the last rate case. For example, executive bonuses may have impeded Avista's ability to attract capital in the equity market, or may be reducing funds available to fund debt reduction. Specifically, in a newspaper article dated February 16, 2006, it was disclosed that Avista's CEO, Gary Ely, received total compensation in 2005 of $2.57 million in the form of salary, bonuses and stock grants.[21/] It states that his compensation was up from $875,000 paid in 2004 and reflects an incentive pay program that tracks the Company's improving financial condition. Further, the same article indicates that other Avista executive bonus pay was significant in calendar year 2005 as well.

The Commission should not continue to increase customer burdens to help Avista accomplish its financial restructuring and regain its investment grade credit rating, unless

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[20/] Docket No. UE-050482 at ¶¶56, 60.

[21/] Exh. No.___(MPG-10).

Avista's shareholders and management make similar commitments. This is particularly of concern while Avista's executives are receiving significant bonus pay prior to the achievement of an investment grade bond rating or its equity building targets. Further, Avista's investors also are receiving benefits during this time of attempted financial recovery in the form of increased dividends. Avista has increased dividends to investors approximately every third quarter since the third quarter in 2003. Indeed, Value Line is projecting approximately a 6% increase in Avista's dividend growth over the next three to five-year period. While this dividend growth will help support Avista's common stock, it erodes the funds available to Avista to pay down debt. Accordingly, Avista seems to be missing some self-help opportunities to fund debt reductions through tight cost management and limited dividend increases.

Q. IS AVISTA'S CURRENT BELOW INVESTMENT GRADE UNSECURED CREDIT RATING CAUSING ITS COST OF DEBT TO BE SIGNIFICANTLY HIGHER THAN ITS COST OF DEBT WOULD BE IF IT HAD AN INVESTMENT GRADE CREDIT RATING?

A. Not currently. In response to ICNU DR No. 1.45, Avista estimated that its secured and unsecured cost of debt currently is 5.75% and 6.10%, respectively.[22/] The spread between Avista's secured and unsecured debt cost is currently extremely low.[23/] Accordingly, Avista's below investment grade unsecured credit standing currently is not causing a significant increase to its cost of borrowing. This is relevant in assessing whether the Commission needs to immediately respond to Avista's proposed ERM modification. The Company currently has access to capital under reasonable terms, conditions and prices, even with a below investment grade unsecured debt rating.

22/ Exh. No.___(MPG-11).
23/ Exh. No.___(MPG-12).

Therefore, the Commission should carefully consider Avista's proposed modifications to its ERM in this proceeding and ensure that the ERM is implemented in a way that properly balances risks between investors and customers.

Q. PLEASE PROVIDE A SUMMARY OF AVISTA'S FINANCIAL PERFORMANCE OVER THE LAST THREE YEARS.

A. In response to ICNU 1.46, Avista indicated it had retired over $495 million of long-term debt between 2002 and 2005. Of that amount, it indicated that $319 million was repurchased high cost debt and the remaining was debt maturities. The debt reduction significantly reduced its annual interest expense and improved its cash flow debt coverages.

It appears Avista now has access to equity capital under reasonable terms because its stock price has recovered since its low of 2002. In 2002 its stock hit a low of $11.65, and in 2006 it has recovered to over $19.00 per share. Its current book value per share in 2005 was $15.70 per share. Hence, the Company can issue additional common equity at prices above book value. This is significant, because the Company can now issue common stock without diluting existing shares. Dilution of shares is generally perceived as a negative factor to existing shareholders. This recovery in stock price improves Avista's access to additional new common equity capital.

Avista's senior secured credit rating remains investment grade, however, its unsecured corporate credit rating is below investment grade. Nevertheless, the market is assigning premiums to low risk stable cash flows from regulated utility operations. Hence, Avista is able to issue below investment grade secured utility debt at a relatively competitive interest rate as discussed above. Therefore, Avista's current cost of borrowing is reasonably favorable, providing it with a means of implementing its financial recovery plan without incurring additional excessive debt costs.

Q. PLEASE GENERALLY DESCRIBE HOW AN EARNINGS TEST SHOULD BE INCLUDED IN ANY MODIFIED ERM PROTOCOL.

A. The earnings test should not be a surrogate for a full base rate filing. Rather, the Company should simply reflect major changes to rate base for plants in service, changes to its embedded cost of debt and preferred stock equity, and reflect all other aspects of the last rate filing.

I recommend the Commission use the same procedures currently used by Avista for electric and gas operating reports filed with the WUTC in accordance with WAC §§ 480-90-275 and 480-100-275. These reporting requirements, which derive the Company's actual earned return on equity, can be compared to the authorized return on equity to determine whether there is an earnings surplus or deficiency, and whether ERM deferrals are justified.

Accordingly, an earnings analysis should be based on Commission approved jurisdictional allocation factors and general rate case issues ruled on by the Commission in the Company's last base rate filing. Reliance on this standard operating reporting format can help minimize issues in determining the Company's annual earnings and in assessing whether those earnings are in excess of or below the last authorized return on equity.

Q. PLEASE PROVIDE ADDITIONAL EXPLANATION OF HOW THE COMMISSION SHOULD REQUIRE ADDITIONAL AMORTIZATION OF POWER COST DEFERRALS AFTER AVISTA REALIZES DEBT INTEREST EXPENSE SAVINGS, OR FAILS TO MEET EQUITY REDUCTION TARGETS AS ADDRESSED ABOVE.

A. The major cost reduction expected during the period base rates in this proceeding may be in effect is the Company's refinancing of expensive debt in 2007 and 2008. The interest rate savings created through this debt refinancing should be recorded in a deferred account and used to accelerate the pay down of deferred power costs if the Company does not make a base rate filing before this interest savings is realized. Also, to the extent the Company fails to meet its equity building targets built into its last rate settlement, adjustments to the power deferral amortization should be increased until the time the Commission adjusts rates prospectively under the terms of the settlement.

Q. DOES ICNU'S PROPOSED MODIFIED ERM, AS DESCRIBED IN WITNESS MR. FALKENBERG'S TESTIMONY, PROVIDE ADEQUATE CREDIT STRENGTH TO ASSIST AVISTA IN ACHIEVING ITS INVESTMENT GRADE BOND RATING OBJECTIVES?

A. Yes. ICNU's proposed ERM deadband and sharing mechanism, as described in Mr. Falkenberg's testimony, is consistent with other Northwest utilities that do have investment grade bond ratings and have business profile scores stronger, that is lower risk, than that of Avista. Hence, the credit implications of this proposed plan are adequate to provide Avista an opportunity to achieve an investment grade bond rating. Importantly, the modified deadband places less ERM cost recovery risk on Avista, and more cost recovery risk on customers. This is a particularly generous plan given the significant customer contributions to Avista's financial recovery contained in the last rate settlement as described above. Therefore, the current ERM deadband does not cause significant credit risk to Avista and is not the primary cause of the current below investment grade unsecured rating status. Hence, the revised ERM, which places more ERM cost recovery risk on customers and less on investors, will provide further customer contributions to Avista to help it achieve its financial recovery plan.

For example, under the current ERM deadband, Avista is responsible for the first $9 million of under-recovery. Under Mr. Falkenberg's proposal Avista will only incur the $9 million of under-recovered ERM costs if its ERM under-recoveries exceed $13 million in any given year. Hence, it provides more cost recovery protection for Avista than that afforded under the current ERM. This additional ERM cost recovery protection, along with the debt reduction plan inherent in the current rate settlement, constitutes significant customer contributions to Avista to help it achieve its financial recovery goals.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes