

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UG-04 _____

DIRECT TESTIMONY OF

MALYN K. MALQUIST

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

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

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

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

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

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

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

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

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

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

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

14 A. Yes. I am sponsoring Exhibit No. ____ (MKM-2), which was prepared
15 under my direction.

16 **II. FINANCIAL OVERVIEW**

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

18 A. During the energy crisis of 2000 and 2001, it was necessary for the
19 Company to issue a significant amount of debt to cover deferred electric and natural gas
20 costs that reached over \$340 million in 2001 on a system basis. The electric deferrals

1 were driven primarily by the combination of record-low hydroelectric conditions and
2 unprecedented high wholesale market prices that occurred in 2001. Wholesale natural
3 gas prices were also very high during the period.

4 During that time investors and lenders were reluctant to invest in the utility
5 industry, including Avista, and were demanding higher interest rates. Much of the debt
6 issued by Avista during this time was at rates exceeding 9%. As a result, Avista's
7 annual interest costs rose from approximately \$69 million in 2000 to over \$105 million in
8 2001 and 2002. In addition, Avista's debt ratio rose to over 59% by December 2001¹.

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

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

14 A. We have been aggressively rebuilding our financial health by improving
15 our cash flow, managing our costs and paying down debt. Since 2001, we repurchased
16 \$293 million of the higher-cost debt. In December 2002, S&P affirmed its credit ratings
17 for Avista and upgraded its credit outlook from negative to stable. In March 2004,
18 Moody's affirmed its credit ratings of Avista and upgraded its ratings outlook to stable
19 from negative.

1 We are making significant strides in improving the Company's financial stability.
2 Our operating cash flow is positive, thanks to a combination of cost management efforts
3 and rate relief by all four of our regulatory jurisdictions. We will continue to
4 aggressively manage all costs that are within our control. Going forward, it is
5 important that the Company attain revenues that provide recovery of its costs, and
6 earned returns that are in line with the returns allowed by our regulators.

7 Our total debt ratio (excluding the impacts of two new accounting standards
8 issued by the Financial Accounting Standards Board (FASB), Statement of Financial
9 Accounting Standards (SFAS) 150 and FASB Interpretation No. (FIN) 46) of
10 approximately 53 percent is down from 59 percent at the end of 2001, but we still need
11 to reduce the debt ratio to below 50 percent if we are to reach our goal of regaining our
12 investment grade rating. The Company's target is to repurchase an additional \$50
13 million of higher cost debt in calendar year 2004. As of the date of this filing, Avista has
14 purchased \$37 million of the target amount.

15 **Q. Please briefly explain the new accounting standards SFAS 150, and FIN**
16 **46, and their affect on the Company?**

17 A. In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain
18 Financial Instruments with Characteristics of Both Liabilities and Equity." More
19 specifically, this statement requires Avista, for reporting purposes, to classify certain

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

1 financial instruments as liabilities that have historically been classified as equity. This
2 statement requires Avista to classify as a liability financial instruments that are subject
3 to mandatory redemption at a specified or determinable date or upon an event that is
4 certain to occur. The adoption of this statement required Avista to classify certain
5 preferred stock subject to mandatory redemption as liabilities on its Consolidated
6 Balance Sheet as of December 31, 2003.

7 In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest
8 Entities," which was revised in December 2003. In general, a variable interest entity
9 does not have equity investors with voting rights or it has equity investors that do not
10 provide sufficient financial resources for the entity to support its activities. FIN 46
11 requires a variable interest entity to be consolidated by the primary beneficiary of that
12 entity.

13 Among other things, FIN 46 required Avista, for reporting purposes, to
14 consolidate on its financial records the lease arrangement related to the Utility's
15 Rathdrum simple-cycle combustion turbine project. The net effect of the consolidation
16 was to increase the amount of long-term debt reflected on Avista's balance sheet. By
17 incorporating the reporting changes required by FAS 150 and FIN 46, as well as
18 differences due to consolidating requirements, Avista's overall long term debt ratio at
19 December 31, 2003 was 56.9% as reported in the Company's 10K.

20 **Q. What are the risks facing Avista and the rest of the utility sector?**

1 A. Among the risk factors are the level and volatility of wholesale market
2 prices, liquidity in the wholesale market (fewer counterparties and tighter credit
3 restrictions), recoverability of natural gas and power costs, streamflow and weather
4 conditions, changes in legislative and governmental regulations, security concerns
5 related to terrorism, and availability of funding. Many of these factors are manifest in
6 the increased earnings volatility the Company has experienced, as well as in the many
7 credit rating downgrades by rating agencies in recent years for utilities across the
8 country. As Mr. Avera will explain in more detail in his testimony, over the last few
9 years in the utility industry, S&P has recorded 182 downgrades, as compared to only 15
10 upgrades in 2002, and 139 downgrades, as compared to only 8 upgrades in 2003.

11 **Q. Please explain further the Company's efforts to improve its financial**
12 **situation.**

13 A. The Company is continuing to rebuild its financial condition in three
14 areas. First, we are working with the financial community to assure we have adequate
15 funds for operations, for capital expenditures and for debt maturities. As I discuss later
16 in my testimony, we are working with our banks to insure that we have adequate
17 liquidity through the availability of our credit facility on the most economic basis
18 possible. We also maintain an ongoing dialogue with the rating agencies regarding the
19 measures being taken by the Company to regain an investment grade credit rating.

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

4 Finally, the Company is working through regulatory processes to recover our
5 costs so that earned returns are closer to those allowed by regulators in each of the
6 states we serve. This is a key determinant from the rating agencies standpoint when
7 they are reviewing our overall credit rating.

8 **Q. What internal measures has the Company taken to conserve cash and**
9 **improve earnings?**

10 A. During the past three years the Company has focused especially on
11 controlling costs and preserving cash through several initiatives. Specific actions that
12 Avista has taken include:

- 13 ▪ Cutting capital expenditures sharply in 2001, and limiting the 2002 through 2004
14 capital budgets.
- 15 ▪ Reductions in operating and maintenance expenses and implementation of strict
16 approval procedures to control expenditures.
- 17 ▪ Implementing hiring restrictions.
- 18 ▪ Reduced the capital commitments otherwise required to fund subsidiaries, including
19 the decision to terminate the Company's involvement in Avista Communications,
20 the sale of 83% of Avista Labs, and discontinuing operations of Avista Power.

- 1 ▪ Payment of significant dividends from Avista Energy to Avista Corporation (Avista
2 Utilities), which were then used to repurchase high cost long-term debt.

3 **Q. In addition to these internal measures, what else has the Company done**
4 **to improve its financial situation?**

5 A. In the past two years the Company has received regulatory approval of a
6 number of measures to address its financial condition. For example, the Company now
7 has tracking mechanisms in place in all of its jurisdictions to provide recovery of the
8 majority of changes in electric and natural gas costs. Some of the recent regulatory
9 approvals are as follows:

- 10 ▪ In June 2002, the Washington Utilities and Transportation Commission (WUTC)
11 approved a settlement agreement, which included an overall electric rate increase of
12 31.2% effective July 1, 2002. Of the 31.2%, 19.2% represented a general rate increase,
13 and the remaining 12% was designed to provide recovery of deferred power costs
14 over time.
- 15 ▪ In June 2002 the WUTC also approved the implementation of an Energy Recovery
16 Mechanism (ERM) effective July 1, 2002. The ERM tracks changes in power costs
17 over time, under the specific terms of the mechanism.
- 18 ▪ In October 2003, the Idaho Public Utilities Commission (IPUC) approved the
19 extension of the 19.4% electric surcharge that continues to provide recovery of the
20 power cost deferral balance in the Idaho jurisdiction.

- 1 ▪ During the Fall of 2003, Avista Utilities received approval of Purchased Gas
2 Adjustment (PGA) filings in all of its jurisdictions— Idaho, Washington, Oregon,
3 and California—which were designed to more closely align the rates paid by
4 customers with the costs to provide service. The Company will continue to
5 periodically file PGAs to align gas costs and revenues and keep gas deferral balances
6 at manageable levels. Large deferral balances lead to additional borrowings from
7 the financial community, and a weaker financial condition for the Company.
- 8 ▪ In September 2003, the Oregon Public Utility Commission (OPUC) approved a
9 natural gas general rate increase of \$6.3 million, or approximately 10%.
- 10 ▪ Avista has pending electric and natural gas general rate increase requests in the
11 State of Idaho for \$31,070,000 (21.24%) electric and \$4,061,000 (7.82%) natural gas.
12 An order from the IPUC is expected in mid-September.

13 This general rate request for natural gas in the State of Washington is another
14 important component of the rate relief necessary to provide recovery of costs incurred
15 to serve customers, and improve our financial condition to provide an opportunity to
16 regain an investment grade credit rating.

17 **Q. Please summarize the recent actions the Company has taken with regard**
18 **to its subsidiaries.**

19 A. In 2001 the Company adjusted its corporate strategy to focus on the
20 energy and energy-related businesses. Since then, we have completely divested our

1 telecommunications subsidiary, Avista Communications, and sold the majority of
2 Avista Labs, the fuel cell company, such that our ownership is now only 17.5%. We
3 have no further obligations to fund that business. Avista Advantage became cash-flow
4 positive in 2003 and virtually requires no cash to fund its operations. Avista Energy
5 continues to be a solid performer and in fact, has provided over \$160 million in cash
6 contributions in the last three years to fund a significant portion of the debt we have
7 repurchased. Our strategy to the future will continue to be focused primarily on the
8 regulated utility and other energy-related businesses.

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

11 **Q. Please explain the ratings for Avista's debt and other securities, and**
12 **what the implications of these ratings are in terms of the Company's ability to access**
13 **financial markets and the Company's financial health.**

14 A. Avista's credit ratings by the three principal rating agencies are
15 summarized on page 1 of Exhibit No. ____ (MKM-2). For each type of investment a
16 potential investor could make, the investor looks at the quality of that investment in
17 terms of the risk they are taking and the priority that they would have in the event that
18 the organization is unable to meet all of its obligations. Investment risks include the
19 likelihood that a company will not meet all of its obligations related to that obligation or
20 security, both in terms of timeliness and amounts owed for principal and interest.

1 Secured debt receives the highest ratings and priority for repayment and, hence, has the
2 lowest relative risk. The highest risk securities are generally common equity shares
3 since they have no priority for payment over other creditors.

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

5 A. Avista Utilities should operate at a level that will support a strong
6 investment grade credit rating, meaning at least a strong "BBB" or weak "A," using
7 S&P's rating scale. This Commission has historically recognized that financially healthy
8 utilities have lower financing costs which, in turn, benefits customers.

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

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

18 Non-investment grade companies are also subject to more restrictive credit
19 requirements from vendors and other counterparties. In fact, the Company's ability to
20 purchase power and natural gas has been impacted by the below-investment grade

1 rating, and there are fewer counterparties willing to do business with us. The lower
2 credit rating also requires the Company to post more collateral with those
3 counterparties that are willing to do business with us than would otherwise be required
4 with a higher credit rating. This results in increased costs. The higher costs of financing
5 for being below investment grade ultimately results in higher rates for our customers.

6 **Q. What events or conditions are necessary for Avista Utilities to regain an**
7 **investment grade credit rating?**

8 A. Improved credit ratings are only likely if the Company's financial strength
9 and its outlook improve for a sustained period of time. To restore satisfactory credit
10 ratings, the Company will need, at a minimum, the following:

- 11 ▪ improved cash flow from operations (higher general revenues),
- 12 ▪ continued regulatory mechanisms in place such as PGAs, PCAs, and the ERM, that
13 will provide more certainty of positive cash flows from operations,
- 14 ▪ reductions in the level of debt that is being carried and the cost of that debt,
- 15 ▪ improved cash coverage of interest charges,
- 16 ▪ consistent and predictable financial results, and
- 17 ▪ the ability to earn a rate of return close to our cost of capital.

18 The effort and sustained performance required to return Avista's credit ratings to
19 investment grade levels will take time, and can be achieved only with the continued
20 support of regulators in allowing the timely recovery of costs. The Company's

1 initiatives to carefully manage its operating costs and capital expenditures are an
2 important part of improving performance, but are not sufficient without revenues that
3 cover costs and provide a fair return on investment.

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IV. CASH FLOW

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

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A. As a combination electric and natural gas utility, over the next few years,
8 capital will be required for customer growth, necessary maintenance and replacements
9 of our natural gas utility systems, as well as investment in generation, transmission and
10 distribution facilities for the electric utility business. In addition, the Company has
11 securities of \$58 million that mature in 2004-2005. The amount of capital expenditures
12 planned for 2004-2005 is approximately \$250 million. We need a combination of
13 adequate cash flow from operations (earnings before interest, taxes, depreciation and
14 amortization, known as "EBITDA" or "internally generated cash") plus the ability to
15 access capital markets to fund these requirements.

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1 collections are received from customers. We have been impacted even more in recent
2 years as the need for liquidity has increased for energy purchases to meet daily, next
3 day and short-term load requirements.

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. As the Natural Gas Benchmark
10 Mechanism is transitioned back to the Utility from Avista Energy, credit requirements
11 are expected to increase at the Utility.

12 Major capital expenditures are a normal part of utility operations. Customers are
13 added to the service area, roads are relocated and require existing facilities to be moved,
14 and facilities continue to wear out and need replacement. These and other
15 requirements create the need for significant capital expenditures each year. Many of the
16 commitments made in the past to provide quality customer service, to insure customer
17 and employee safety, and to respond to regulatory or licensing requirements at the
18 Company's facilities must be funded. Issuance of securities depends upon the
19 Company maintaining an adequate capital structure, sufficient interest coverage, and
20 investment grade credit ratings to be able to access capital at reasonable costs.

1 **Q. What is the status of the Company's short-term line of credit?**

2 A. The bank market has improved in the last year and acquiring credit from
3 the banks has eased to some degree. In 2002, we had to secure our credit line with First
4 Mortgage Bonds whereby the banks now have the same ranking in priority as our other
5 First Mortgage Bond holders. While our financial condition has improved, the banks
6 continue to require the safety of a line secured by bondable utility property. In May
7 2004, the Company's line of credit was amended to increase the available amount from
8 \$245 million to \$350 million and extend the expiration date to May 5, 2005. The credit
9 line was increased to accommodate possible increases in liquidity requirements and the
10 potential for consolidations within the banking industry. The facility needs to be large
11 enough to allow the Company to fund at least one year of capital expenditures, plus
12 required working capital and counterparty collateral requirements to assure flexibility
13 given volatile financial markets, and especially given the recent volatility of energy
14 commodity costs. The Company's current credit rating is non-investment grade,
15 however; with an investment grade credit rating, the Company could expect lower fees
16 and borrowing costs.

17 **Q. How does equity capital fit into a sound financial plan for Avista?**

18 A. Avista needs to improve the common equity ratio of its capital structure.
19 The company is accomplishing this through continuing to buy down debt, as well as
20 improvement to retained earnings.

1 We do not have current plans to issue equity, other than the small amounts to
2 fund the requirements of our dividend reinvestment and employee benefit plans, and
3 are concentrating on lowering our debt ratio and improving the common equity ratio
4 through current cash flows. The more flexibility the Company has by maintaining
5 access to both the debt and equity markets, the stronger our financial condition will
6 become. The opportunity to earn our allowed return on equity will continue to build
7 the equity ratio, and improve the Company's financial condition.

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V. CAPITAL STRUCTURE

10 **Q. When you use the terms "cost of capital" and "capital structure" in your**
11 **testimony, what are you referring to?**

12 A. Cost of capital is the amount that an investor in a specific security charges
13 the user of money. It is generally stated in terms of an interest rate or percentage of
14 expected return on investment. Capital structure refers to the collective set of funding
15 provided by all investors to provide the necessary funds to operate that company.
16 When all the components of capital are aggregated for the company's overall capital
17 structure, the weighted average cost of those components is the "cost of capital" for the
18 firm.

19 **Q. What is Avista Corp's capital structure and how does it impact the rate**
20 **of return?**

1 A. Avista's capital structure consists of the blend of long-term debt, preferred
2 trust securities, preferred equity and common equity necessary to support the assets
3 and operating capital of the utility. The proportionate shares of Avista Corp's actual
4 capital structure on December 31, 2003, are shown on page 2 of Exhibit No. ___(MKM-2).
5 A pro forma capital structure is also shown in the Exhibit, which reflects known and
6 projected changes in long-term debt and preferred equity through June 30, 2005.

7 The rate of return to be applied against rate base in this proceeding is equal to the
8 weighted average cost of capital, taking into account the pro forma adjusting items. As
9 shown on page 2 of Exhibit No. ___(MKM-2), Avista Utilities is proposing an overall rate
10 of return of 9.86%.

11 The level of debt in the capital structure continues to be above the desired level
12 for Avista Utilities to achieve and maintain an investment grade credit rating, but we
13 did see improvement in 2002 and 2003 and we expect a continued improvement in 2004
14 and beyond.

15 **Q. How does Avista conduct its financing as a combined electric and**
16 **natural gas utility?**

17 A. Avista provides electric service in Washington and Idaho and natural gas
18 service in Washington, Idaho, Oregon and California. Our funding for both the electric
19 and natural gas services is provided through a central treasury function. It is more

1 efficient and cost-effective to pool our resources rather than attempting to fund each of
2 them separately.

3 As a combination electric and natural gas utility that operates in an area
4 spanning parts of four states, all customers share in the costs of service, cost of capital,
5 and the level of service provided. Reasonable allocations can be made to determine the
6 fair sharing of costs between services and among jurisdictions. Distinctions between the
7 cost of capital between services and jurisdictions would be difficult to determine and
8 unsupportable by the facts of how capital is obtained and used for the entirety of utility
9 operations.

10 VI. COST OF DEBT

11 **Q. Please describe the Company's use of debt.**

12 A. Avista Utilities obtains part of its capital needs through debt rather than
13 all of it from equity owners. By borrowing part of its capital requirements, the overall
14 cost of capital can be reduced since, most often, the cost of debt is lower than the
15 expected returns on equity. Debt holders have superior rights to repayment over equity
16 investors, which reduces their investment risk. Equity holders receive their investment
17 returns only after debt commitments have been satisfied. However, the cost of debt is
18 not generally directly tied to the company's profits; it doesn't change, in general, with
19 the fluctuating net income level of the firm. However, if income fluctuates negatively it

1 does become more difficult to meet fixed charge coverage ratios that are required in
2 virtually all bank and debt financing today.

3 **Q. What is the time period chosen for the cost of debt included in this case?**

4 A. The Company is proposing a capital structure and cost of long-term debt
5 based on actual results at December 31, 2003, with adjustments to reflect known and
6 projected changes in long-term debt issuances/redemptions and associated costs
7 through June 30, 2005. Adjustments through this time period are intended to coincide
8 with the approximate timing of the Commission's final order in this case.

9 **Q. How have you determined the cost of debt?**

10 A. As shown on page 2 of Exhibit No. ____ (MKM-2), the average actual cost of
11 long-term debt outstanding on December 31, 2003 was 8.68%, which is a weighted
12 average of all long-term debt components. The size and mix of debt funding changes
13 over time. We have made certain pro forma adjustments to update the debt cost
14 through June 30, 2005 to 8.81%. These adjustments reflect expected maturities of
15 outstanding debt, required preferred sinking fund purchases, changes in interest rate on
16 trust preferred securities and planned repurchase of 9.75% notes. Supporting
17 workpapers provide additional details related to these adjustments.

18 **Q. What has Avista Utilities done recently to lower its cost of debt?**

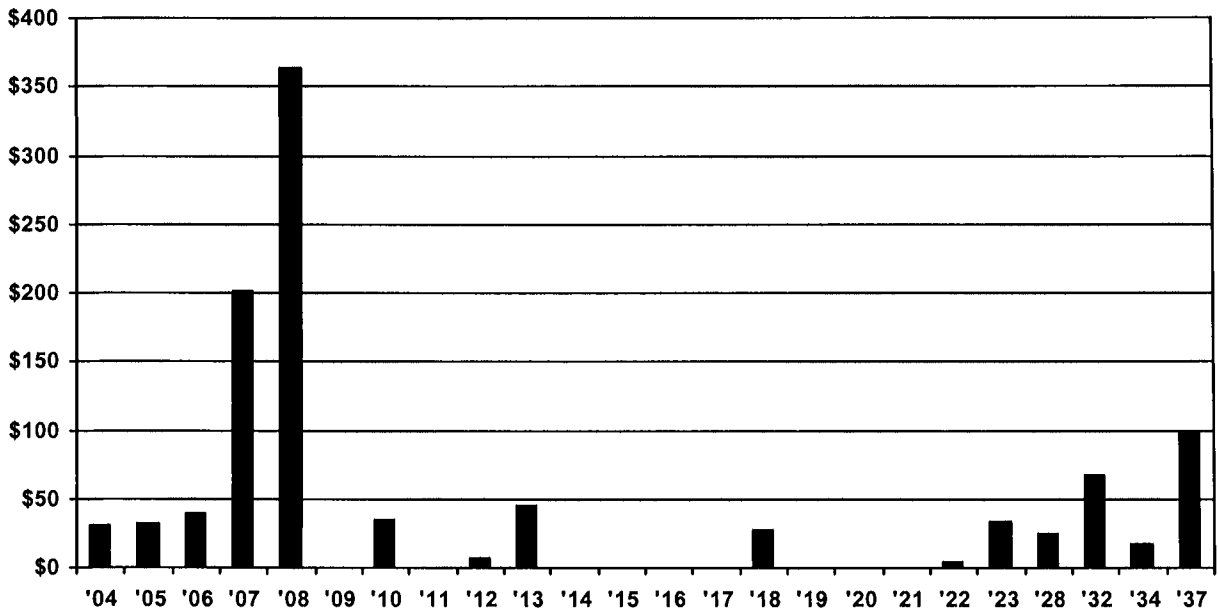
19 A. During 2002, 2003 and 2004 we repurchased \$293 million of debt on the
20 open market in an effort to reduce interest costs. Our plan is to carry total debt below

1 50% of total capital, excluding the effects of the new Accounting Standards FAS 150 and
2 FIN 46, and to take advantage of opportunities that may allow us to reduce the cost of
3 debt. However, the Company's present credit ratings are below investment grade and
4 the alternatives available to us are somewhat limited. It is critical that the Company
5 continue to improve its cash flows and earnings. Our cost of debt is higher than it
6 would be with an investment grade rating. Improved financial performance must be
7 sustained if we are to expect the rating agencies to restore Avista Corp's investment
8 grade credit rating.

9 As we look to the future, the Company has over 50% of its total debt maturing in
10 2007 and 2008, as shown in the chart below. A stronger credit rating would allow the
11 Company to refinance the debt at lower interest rates. Therefore, it is important for the
12 Company to regain its financial health and credit ratings, quickly, which will result in
13 lower financing costs for customers in the future.

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**Future Debt Maturities By Year
As of December 31, 2003**



VII. COST OF PREFERRED EQUITY

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

A. Preferred equity securities have attributes that are similar to both debt and to common equity. Certain investors are interested in owning preferred securities rather than common equity because of the greater certainty of a specified return on preferred securities than common stock. Preferred securities often have a longer term or an indefinite maturity than typical debt securities, which is attractive to certain investors. Because of their unique niche in the capital structure, preferred securities have specific covenants and restrictions that must be carefully considered in light of our long-term financing needs and ability to adapt to changing situations. In the past,

1 Avista Utilities has been able to issue preferred securities with costs and terms that are
2 advantageous to our capital structure.

3 However, there is a limited capacity to use preferred equity as part of the overall
4 capital structure. The rating agencies assign various levels of "equity credit" to
5 preferred equity depending on the specific structure and the company's credit rating.
6 The higher the credit rating, the lower the level of equity treatment given and vice
7 versa. In addition, Generally Accepted Accounting Principles (GAAP) changed in 2003
8 whereby trust-preferred securities are now treated as "debt" on the balance sheet.
9 While the Company currently has about 7.5% of its capital structure in preferred
10 securities, to the future, we will be focusing more on improving the common equity
11 ratio and reducing the total debt ratio rather than specifically focusing on a targeted
12 preferred stock ratio target. To issue new preferred securities, the financial markets and
13 the company's financial condition must support the needs of a particular form of
14 preferred securities and a particular investor group's appetite to buy them. We monitor
15 market trends and evaluate opportunities to see what the best alternatives are for the
16 Company to pursue.

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

18 A. Preferred equity, which includes both trust preferred securities and
19 preferred stock, comprised 7.53% of Avista Utilities' capitalization, including proforma
20 adjustments through June 30, 2005. We have included the actual cost of preferred

1 equity in our calculation of weighted average cost of capital shown on page 2 of Exhibit
2 No. ____ (MKM-2).

3 **VIII. COST OF COMMON EQUITY**

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

6 A. The company is proposing an 11.5% return on common equity (ROE). Dr.
7 William Avera testifies to analyses related to the cost of common equity for a
8 benchmark group of utilities in the western U.S., with an ROE range of 10.2% to 12.4%.
9 In his testimony Dr. Avera states that:

10 The investment risks associated uniquely with Avista, however,
11 are significantly greater than those of the utilities in the
12 benchmark group and so investors require a higher rate of return
13 to compensate for that risk. (P. 6, L. 12)
14

15 Dr. Avera further states in his testimony that:

16 Based on my capital market analyses, I conclude that a 11.5
17 percent ROE falls below the current required rate of return for
18 Avista, in light of investors' economic requirements for utility
19 operations and the Company's specific risks. (P. 6, L. 7)
20

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

23 A. As I have testified, the Company has made progress in its efforts to regain
24 financial health. If Avista can earn an 11.5% ROE in 2005, I believe the financial results

1 would support a bond rating upgrade to investment grade within a reasonable period
2 of time.

3 Furthermore, as the Company has worked toward regaining its financial health
4 over the last few years, it has done so with the customer in mind. Avista has attempted
5 to balance the time frame for financial recovery with the impacts that increased retail
6 rates have on its customers.

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

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

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

<u>Component</u>	<u>Percentage</u>	<u>Cost</u>	<u>Weighted Cost</u>
Total long-term debt	45.75%	8.81%	4.03%
Trust preferred securities	5.80%	5.69%	0.33%
Preferred equity	1.73%	7.37%	0.13%
Common equity	<u>46.72%</u>	11.50%	<u>5.37%</u>
Total Weighted Cost of Capital	100.00%		9.86%

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

2 **A. Yes.**

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UG-04 _____

EXHIBIT NO. ____ (MKM-2)

MALYN K. MALQUIST

REPRESENTING AVISTA CORPORATION

AVISTA CORPORATION
Long-term Securities Credit Ratings

	Standard & Poor's	Moody's	Fitch
Last Reviewed	December 2002	June 2004	December 2001
Credit Outlook	Stable	Stable	Stable
Business Profile	5	N/A	N/A
AAA		Aaa	AAA
AA+		Aa1	AA+
AA		Aa2	AA
AA-		Aa3	AA-
A+		A1	A+
A		A2	A
A-		A3	A-
BBB+		Baa1	BBB+
BBB		Baa2	BBB
BBB-	First Mortgage Bonds Secured Medium-Term Notes	baa3 First Mortgage Bonds Secured Medium-Term Notes	BBB- First Mortgage Bonds Secured Medium-Term Notes
INVESTMENT GRADE			
BB+	Avista Corp./Corporate rating Unsecured Medium-Term Notes Senior Corporate Notes 9.75%	Ba1 Avista Corp./Issuer rating Unsecured Medium-Term Notes Senior Corporate Notes 9.75%	BB+ Unsecured Medium-Term Notes Senior Corporate Notes 9.75% Trust-Originated Preferred Securities (TOPS) Cap I
BB		Ba2 Trust-Originated Preferred Securities (TOPS)	BB Preferred Stock
BB-	Preferred Stock Trust-Originated Preferred Securities (TOPS)	Ba3 Preferred Stock	BB- Trust-Originated Preferred Securities (TOPS) Cap II

AVISTA CORPORATION
Capital Structure and Overall Rate of Return

PROFORMA

Cost of Capital

	<u>Amount</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Component</u>
Total Long Term Debt	\$788,187,509	45.75%	8.81%	4.03%
Trust Preferred Securities	100,000,000	5.80%	5.69%	0.33%
Preferred Stock	29,750,000	1.73%	7.37%	0.13%
Common Equity	<u>804,841,500</u>	<u>46.72%</u>	11.50%	<u>5.37%</u>
TOTAL	<u><u>\$1,722,779,009</u></u>	<u><u>100.00%</u></u>		<u><u>9.86%</u></u>

EMBEDDEDCost of Capital as of
December 31, 2003

	<u>Amount</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Component</u>
Total Long Term Debt	\$898,822,426	50.08%	8.68%	4.35%
Trust Preferred Securities	100,000,000	5.57%	6.15%	0.34%
Preferred Stock	31,500,000	1.76%	7.35%	0.13%
Common Equity	<u>764,290,875</u>	<u>42.59%</u>	11.50%	<u>4.90%</u>
TOTAL	<u><u>\$1,794,613,301</u></u>	<u><u>100.00%</u></u>		<u><u>9.72%</u></u>