

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-15\_\_\_\_\_

DOCKET NO. UG-15\_\_\_\_\_

DIRECT TESTIMONY OF

MARK T. THIES

REPRESENTING AVISTA CORPORATION

1 **I. INTRODUCTION**

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

4 A. My name is Mark T. Thies. My business address is 1411 East Mission  
5 Avenue, Spokane, Washington. I am employed by Avista Corporation as Senior Vice  
6 President, Chief Financial Officer and Treasurer.

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

8 A. I received a Bachelor of Arts degree in 1986 with majors in Accounting and  
9 Business Administration from Saint Ambrose College in Davenport, Iowa, and became a  
10 Certified Public Accountant in 1987. I have extensive experience in finance, risk  
11 management, accounting and administration within the utility sector.

12 I joined Avista in September of 2008 as Senior Vice President and Chief Financial  
13 Officer (CFO). Prior to joining Avista, I was Executive Vice President and CFO for Black  
14 Hills Corporation, a diversified energy company, providing regulated electric and natural  
15 gas service to areas of South Dakota, Wyoming and Montana. I joined Black Hills  
16 Corporation in 1997 upon leaving InterCoast Energy Company in Des Moines, Iowa, where  
17 I was the manager of accounting. Previous to that I was a senior auditor for Arthur  
18 Anderson & Co. in Chicago, Illinois.

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

20 A. I will provide a financial overview of Avista Corporation as well as explain  
21 the proposed capital structure, overall rate of return, and our credit ratings. Additionally, I  
22 will summarize our capital expenditures program. Mr. Adrien McKenzie, on behalf of  
23 Avista, will provide additional testimony related to the appropriate return on equity for

1 Avista, based on our specific circumstances, together with the current state of the financial  
2 markets.

3 In brief, I will provide information that shows:

- 4 • Avista's plans call for making significant utility capital investments in generation,  
5 transmission and distribution systems to preserve and enhance service reliability for our  
6 customers, including the replacement of aging infrastructure. Capital expenditures of  
7 \$726 million are planned for 2015-2016. Capital expenditures of approximately \$1.8  
8 billion are planned for the five-year period ending December 31, 2019. Avista needs  
9 adequate cash flow from operations to fund these requirements, together with access to  
10 capital from external sources under reasonable terms, on a sustainable basis.
- 11 • We are proposing an overall rate of return of 7.46 percent, which includes a 48.0 percent  
12 common equity ratio, a 9.9 percent return on equity, and a cost of debt of 5.20 percent.  
13 We believe our proposed overall rate of return of 7.46 percent and proposed capital  
14 structure provide a reasonable balance between safety and economy.
- 15 • Avista's corporate credit rating from Standard & Poor's is currently BBB and Ba1 from  
16 Moody's Investors Service. Avista must operate at a level that will support a solid  
17 investment grade corporate credit rating in order to access capital markets at reasonable  
18 rates. A supportive regulatory environment is an important consideration by the rating  
19 agencies when reviewing Avista. Maintaining solid credit metrics and credit ratings will  
20 also help support a stock price necessary to issue equity under reasonable terms to fund  
21 capital requirements.
- 22 • Avista completed two significant business unit transactions in 2014: the sale of Ecova  
23 and the acquisition of Alaska Electric Light and Power utility operations. These  
24 transactions are supportive to our business profile and their financial impacts have  
25 positively complemented our ongoing financial structure and operations.

26

1 A table of contents for my testimony is as follows:

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

12 A. Yes. I am sponsoring Exhibit No.\_\_\_\_ (MTT-2) pages 1 through 6, which  
 13 were prepared under my direction. Avista's credit ratings by S&P and Moody's are  
 14 summarized on page 1, and Avista's embedded capital structure at December 31, 2014, and  
 15 proposed capital structure at December 31, 2015, are included on page 2, with supporting  
 16 information on pages 3 through 6. Confidential Exhibit No.\_\_\_\_ (MTT-3C) includes our  
 17 Interest Rate Risk Management Plan. Exhibit No.\_\_\_\_ (MTT-4) includes the equity ratios  
 18 and returns on equity approved by various state regulatory commissions from July 1, 2014,  
 19 through December 31, 2014. Confidential Exhibit No.\_\_\_\_ (MTT-5C) includes the  
 20 Company's planned capital expenditures and long-term debt issuances by year.

21  
 22 **II. FINANCIAL OVERVIEW**

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

24 A. We are operating the business efficiently to keep costs as low as practicable  
 25 for our customers, while at the same time ensuring that our energy service is reliable and  
 26 customer demands are met. An efficient, well-run business is not only important to our

1 customers but also important to investors. We plan and execute on a capital financing plan  
2 that provides a prudent capital structure and liquidity necessary for our operations. We  
3 initiate regulatory processes to recover our costs in a timely manner with the goal of  
4 achieving earned returns close to those allowed by regulators in each of the states we serve.  
5 These elements – cost management, capital and revenues that support operations – are key  
6 determinants to the rating agencies when they are reviewing our overall credit ratings.

7 **Q. What steps is the Company taking to maintain and improve its financial**  
8 **health?**

9 A. We are working to assure there are adequate funds for operations, capital  
10 expenditures and debt maturities. We obtain a portion of these funds through the issuance of  
11 long-term debt and common equity. We actively manage risks related to the issuance of  
12 long-term debt through our interest rate risk mitigation plan and we maintain a proper  
13 balance of debt and common equity through regular issuances and other transactions. We  
14 create financial plans and forecasts to model our income, expenses and investments,  
15 providing a basis for prudent financial planning. We seek timely recovery of our costs  
16 through general rate cases and other ratemaking mechanisms.

17 The Company currently has a sound financial profile and it is very important for  
18 Avista to maintain and enhance its financial position in order to access debt and equity  
19 financing as Avista funds significant future capital investments and refinances maturing  
20 debt.

1 **III. BUSINESS UNIT TRANSACTIONS IN 2014**

2 **Q. The Company completed two significant business unit transactions in**  
3 **2014. Please give an overview of these transactions.**

4 A. On June 30, 2014, the Company completed the sale of its former Ecova  
5 business unit in a cash transaction to Cofely USA Inc, an indirect subsidiary of GCF SUEZ,  
6 a French multinational utility company. On July 1, 2014, the Company acquired Alaska  
7 Energy and Resources Company (AERC) by issuing Avista common stock to the holders of  
8 AERC common stock in exchange for their shares. AERC's primary subsidiary is Alaska  
9 Electric Light and Power Company (AEL&P), which provides electric service to the City  
10 and Borough of Juneau, Alaska. These business unit transactions also led the Company to  
11 implement a common stock share repurchase program.

12 **Q. How did the Ecova sale transaction affect Avista's capital structure?**

13 A. Avista received cash for the sale of Ecova. The price for the Ecova sale was  
14 \$335 million, which was reduced for payment of debt and other customary closing  
15 adjustments. After repayment of debt and payments to Ecova option holders and non-  
16 controlling interests, and deductions for transaction expenses and a portion of proceeds held  
17 in escrow, the net cash to Avista at closing was \$205.4 million. Avista's gain on the  
18 transaction resulted in income tax obligations of approximately \$85.8 million. Avista  
19 expects to receive approximately \$13.6 million from the escrow later in 2015, resulting in  
20 total net cash proceeds to Avista of \$133.2 million. Certain post-closing adjustments may  
21 affect the final net proceeds and an indemnity escrow will be held until 15 months after the  
22 transaction closed.

1           The cash proceeds received on June 30, 2014, were initially used to reduce Avista's  
2 outstanding borrowings on the short-term bank credit facility, which reduced the outstanding  
3 balance from \$151.5 million to zero, and a portion of the cash was placed in temporary  
4 investments.

5           **Q.     How did the AERC acquisition transaction, which closed on July 1, 2014,**  
6 **affect Avista's capital structure?**

7           A.     We initially funded this acquisition with the issuance of Avista common  
8 stock in exchange for the outstanding shares of AERC common stock. The purchase price  
9 for AERC at closing was \$170 million, plus acquired cash of \$19.7 million less the  
10 assumption of \$38.8 million of outstanding debt and other closing adjustments per the  
11 merger agreement. The Avista common stock issued in exchange for AERC common stock  
12 was valued under the merger agreement at \$32.46 per share, resulting in issuance of 4.5  
13 million new shares of Avista common stock. The value of these shares based on the day of  
14 issue at a market price of \$33.35 per share was \$150.1 million. The transaction also  
15 required a cash payment of \$4.7 million.

16           Following the closing of the transaction, debt was issued by AEL&P and by AERC  
17 to rebalance the capital structure of AERC and AEL&P. AEL&P issued \$75 million of first  
18 mortgage bonds, backed by the assets of AEL&P, and paid off all of its outstanding debt  
19 (excluding debt related to a purchased power contract)<sup>1</sup>. AEL&P paid a \$50 million  
20 dividend (via its parent, AERC) to Avista. AERC entered into a \$15 million five-year term  
21 loan and paid a \$15 million dividend to Avista. These funds from AERC and AEL&P were  
22 transferred to Avista, providing funds for utility capital investment and utility operating

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<sup>1</sup>AERC's debt and debt percentages referred to in this testimony exclude the debt obligation related to a power purchase agreement (PPA) contract held by AEL&P related to the Snettisham hydro electric generation facility.

1 costs at Avista, and reduced Avista's external financing that would have otherwise occurred  
2 without these transactions. At December 31, 2014 AERC's capital structure was 49.7%  
3 equity and 50.3% debt.

4 AERC became a wholly-owned corporation of Avista. AEL&P, a vertically  
5 integrated electric utility providing electric service to the City and Borough of Juneau,  
6 continues to be a wholly-owned corporation of AERC. AERC and AEL&P are separate  
7 legal entities and their debt is backed by the assets and equity of AERC and AEL&P, and  
8 holders of their debt have no recourse against Avista. Avista does not provide collateral or  
9 guarantees related to AERC or AEL&P debt. The debt and equity of AERC are excluded  
10 from the capital structure proposed in Avista's Washington rate filings.

11 **Q. How did Avista's share repurchase program affect the Company's**  
12 **capital structure?**

13 A. As I described earlier, we received cash proceeds from the sale of Ecova and  
14 we issued common stock to acquire AERC. The cash sale of Ecova and acquisition of  
15 AERC through the issuance of equity were completed, almost simultaneously, midway  
16 through 2014. We also completed new debt transactions to recapitalize AERC and AEL&P  
17 during the second half of 2014. These transactions provided a significant amount of cash to  
18 Avista, added significant equity to Avista's capital structure, and decreased debt. As a  
19 result, the Company carried a higher level of common equity during 2014 than it has in  
20 recent years.

21 The Company entered into a common stock repurchase program in 2014 to acquire  
22 shares of Avista common stock with cash. The share repurchase program was designed to  
23 reduce equity and move our overall capital structure closer to our target of approximately



1 48% equity.

2 We implemented a share repurchase program in June of 2014, prior to closing on the  
3 Ecova sale and contingent on the Ecova sale being completed as planned. The program  
4 allowed open market purchases of Avista common shares to start on July 7, 2014, with  
5 repurchase transactions carried out by an agent independent of Avista. The program  
6 authorized up to four million shares to be repurchased by December 31, 2014, subject to  
7 various parameters that were set in June 2014. Daily volumes and prices were dependent on  
8 the market for Avista shares. The Company retained the right to terminate the program at  
9 any time and could not guaranty that the authorized number of shares would be repurchased.  
10 When the program expired December 31, 2014, the repurchases totaled 2,529,615 shares at a  
11 total cost of \$79.9 million for an average cost of \$31.57 per share. On December 31, 2014,  
12 Avista's common equity percentage for the Washington jurisdiction was 49%.

13 We implemented a second share repurchase program in December 2014, based on an  
14 expectation that the 2014 program would not reach the four million share maximum before  
15 it expired on December 31, 2014. Again, the program was designed to reduce equity and  
16 move our capital structure closer to the 48% equity level. The second program authorizes  
17 up to 800,000 shares to be purchased during the first quarter of 2015, subject to certain daily  
18 volume and price parameters. The Company retains the right to terminate the program at  
19 any time and cannot guaranty that the full number of authorized shares will be repurchased  
20 by the March 31, 2015, program expiration date.

1 **IV. CAPITAL EXPENDITURES**

2 **Q. What is the recent history of the Company's capital investment**  
3 **program?**

4 A. We are making significant capital investments in electric generation,  
5 transmission and distribution facilities, and in our natural gas distribution system to better  
6 serve the needs of our customers. These investments target the preservation and  
7 enhancement of safety, service reliability, and the replacement of aging infrastructure. For  
8 the period 2011 through 2014, our capital expenditures totaled \$1.15 billion. While there  
9 are natural variations among the functional areas targeted for investment each year, the  
10 predominant areas have included electric generation, transmission and distribution facilities,  
11 natural gas distribution plant, new customer connects, environmental and regulatory  
12 requirements, information technology and other supporting functions, such as fleet services  
13 and facilities.

14 **Q. In general, has the overall level of capital investment during these years**  
15 **(2011-2014) matched the annual capital requests submitted by the Company's various**  
16 **departments?**

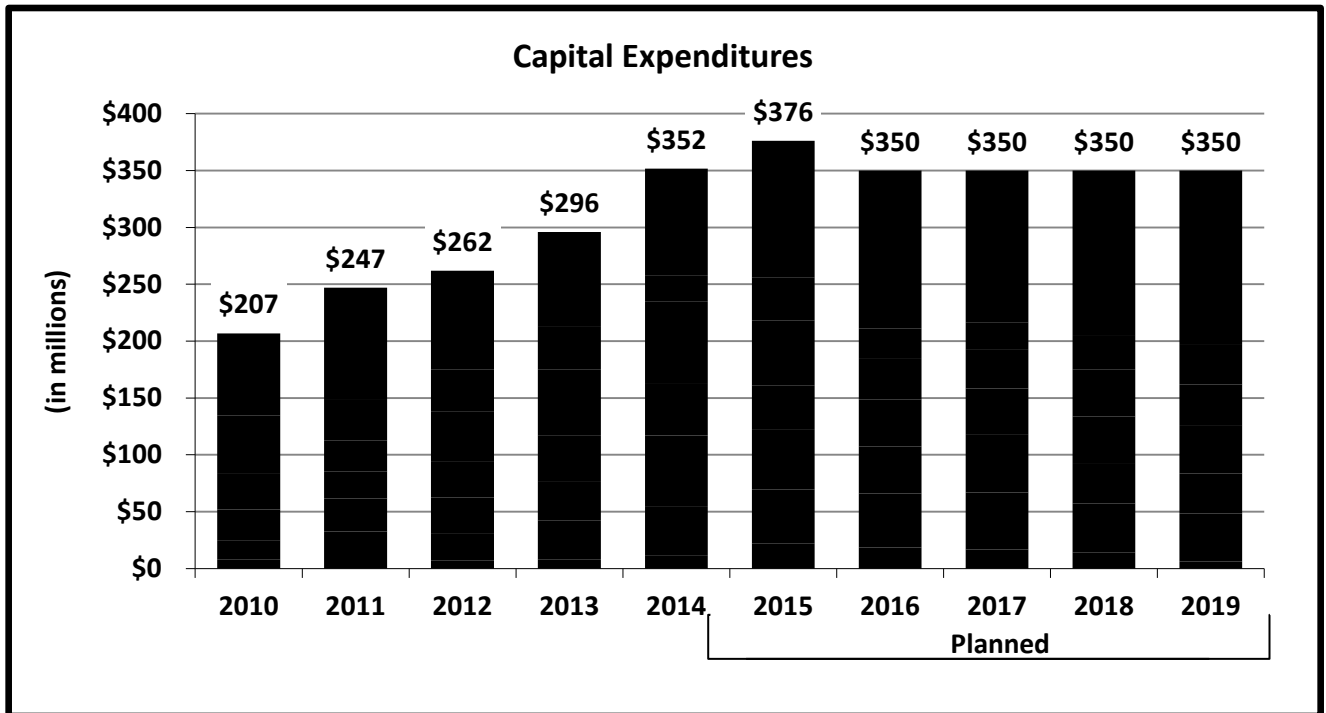
17 A. No. As Ms. Schuh explains in her testimony, Avista has a Capital Planning  
18 Group that meets regularly to review and prioritize proposed utility capital investment  
19 projects. Avista has typically chosen not to fund all of the capital investment projects  
20 proposed by the various departments, driven primarily by the Company's desire to mitigate  
21 the retail rate impacts to customers. Decisions to delay funding certain projects are made  
22 only in cases where the Company believes the amount of risk associated with the delay is  
23 reasonable and prudent.

1           **Q.    What does Avista consider in setting the overall level of capital**  
2 **investment each year?**

3           A.    A range of factors influences the level of capital investment made each year,  
4 including: 1) the level of investment needed to meet safety, service and reliability objectives  
5 and to further optimize our facilities; 2) the degree of overall rate pressure faced by our  
6 customers; 3) the variability of investments required for major projects; 4) unanticipated  
7 capital requirements, such as an unplanned outage on a large generating unit; 5) the cost of  
8 debt; and 6) the opportunity to issue equity on reasonable terms.

9           **Q.    What are Avista’s recent capital expenditure levels and what do you**  
10 **expect them to be for the next five years?**

11          A.    The Company steadily increased its capital investments in utility assets each  
12 year from 2010 through 2014. We expect to continue investing at a similar level as 2014 for  
13 the next five years, with a slightly higher amount in 2015 to complete certain larger projects.  
14 The chart in Illustration No. 1 below shows capital expenditures grew from \$207 million in  
15 2010 to \$352 million in 2014.

1 **Illustration No. 1**

10 After the Company's expected \$376 million capital investments in 2015, the capital  
 11 expenditure level is expected to be \$350 million annually from 2016 through 2019.

12 **Q. Why did the Company increase the level of its capital expenditures?**

13 A. Three primary drivers have affected Avista's level of capital investment: 1)  
 14 the business need to fund a greater portion of the departmental requests for new capital  
 15 investments that in the past were unfunded, 2) the need to capture investment opportunities  
 16 and benefits identified by our asset management capabilities, and 3) a continued focus on  
 17 controlling the increase in operation and maintenance (O&M) spending through prudent  
 18 capital investment.

19 **Q. Please provide some examples that illustrate the key drivers.**

20 A. Our aging and changing infrastructure provides several challenges we need to  
 21 manage to keep costs under control into the future. Asset management programs and  
 22 projects include wood pole management, Aldyl-A pipe replacement, transmission line

1 rebuilds, and substation equipment replacements and rebuilds. These asset management  
2 capital investments are replacing old and failing assets using a planned and systematic  
3 approach to reduce outages, control costs to benefit customers over the life of these assets,  
4 and reduce risks associated with failed equipment.

5 **Q. Are there other reasons Avista believes this increased level of capital**  
6 **spending is appropriate?**

7 A. Yes. Interest rates remain near all-time lows, so funding these capital  
8 projects now will result in a lower long-term cost to customers, rather than waiting until  
9 interest rates and inflation rise. In addition, Avista currently does not have a need for new  
10 capacity and energy resources or new renewable resources, which would otherwise put  
11 upward pressure on retail rates. Furthermore, electric and natural gas commodity costs  
12 continue to be relatively stable as compared to past years, and are expected to remain  
13 relatively stable for the near future.

14 Funding the additional needed capital investment projects now will result in lower  
15 overall bill impacts to customers rather than waiting until a time when retail rates are being  
16 driven higher by increasing commodity costs, construction of new capacity and energy  
17 resources, and/or higher inflation and interest rates.

18

19

#### **V. MATURING DEBT**

20 **Q. How is Avista affected by maturing debt obligations in the next five**  
21 **years?**

22 A. In the next five years the Company is obligated to repay maturing long-term  
23 debt totaling \$452.5 million. The table in Illustration No. 2 below shows the Company's

1 maturing long-term debt from 2015 through 2019. Within this five-year period, a large  
 2 concentration – \$272.5 million – matures within the second quarter of 2018.

3 **Illustration No. 2**

Avista Corp. Long-Term Debt Maturities, 2015 to 2019				
Maturity Year	Principal Amount	Coupon Rate	Date Issued	Maturity Date
2015	\$0	-	-	-
2016	\$ 90,000,000	0.840%	8-14-2013	8-14-2016
2017	\$0	-	-	-
2018	\$7,000,000	7.390%	5-11-1993	5-11-2018
	\$250,000,000	5.950%	4-3-2008	6-1-2018
	\$15,500,000	7.450%	6-9-1993	6-11-2018
2019	\$90,000,000	5.450%	11-18-2004	12-1-2019
<b>Total</b>	<b>\$452,500,000</b>			

11 These debt obligations originated as early as 1993 and their original terms were  
 12 three, ten, fifteen and twenty-five years. These maturing obligations represent nearly a third  
 13 (32.5%) of the Company's long-term debt outstanding at the end of 2014, which is a  
 14 significant portion of our capital structure. The Company typically replaces maturing long-  
 15 term debt with new issuances of debt. It will be necessary for Avista to be in a favorable  
 16 financial position to complete the expected debt refunding, while also obtaining debt and  
 17 equity to fund capital expenditures each year.

18 **Q. What are the Company's expected long-term debt issuances through**  
 19 **2019?**

20 A. To provide adequate funding for the significant capital expenditures noted in  
 21 Section IV above and to repay maturing long-term debt, we are forecasting the issuance of  
 22 long-term debt in each year through 2019. We plan to issue \$120 million in 2015.

1 Issuances planned for 2016 through 2019 are provided in confidential Exhibit No. (MTT-  
2 5C).

3 **Q. Are there other debt obligations that the Company must consider?**

4 A. Yes. In addition to long-term debt, the Company's \$400 million revolving  
5 credit facility expires in April 2019. The Company relies on this credit facility to provide,  
6 among other things, funding to cover month-to-month variations in cash flows, interim  
7 funding for capital expenditures, and credit support in the form of cash and letters of credit  
8 that are required for energy resources commitments and other contractual obligations. Our  
9 credit facility was amended in April 2014, which stretched the expiration date to April 2019,  
10 five years past the amendment date, and reduced interest rates and fees. We expect to  
11 initiate the renewal or replacement of the credit facility before the existing arrangement  
12 expires. Any outstanding balances borrowed under the revolving credit facility become due  
13 and payable when the facility expires. Again, a strong financial position will be necessary to  
14 gain access to a new or renewed revolving credit facility prior to expiration of the existing  
15 facility.

16

17

## **VI. CAPITAL STRUCTURE**

18 **Q. What capital structure and rate of return does the Company request in**  
19 **this proceeding?**

20 A. Our requested capital structure is 52.0 percent total debt and 48.0 percent  
21 equity with a requested overall rate of return in this proceeding of 7.46 percent, as shown in  
22 Illustration No. 3 below. The requested capital structure is based on our forecast capital  
23 structure at December 31, 2015.

**Illustration No. 3**

<b>AVISTA CORPORATION</b>				
<b>Proposed Cost of Capital</b>				
<b>December 31, 2015</b>				
	<u>Amount</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Component Cost</u>
Total Debt	\$ 1,613,000,000	52%	5.20%	2.71%
Common Equity	\$ 1,489,671,000	48%	9.90%	4.75%
Total	<u>\$ 3,102,671,000</u>	<u>100%</u>		<u><b>7.46%</b></u>

**Q. Is the capital structure reflected in Illustration No. 3 above calculated in a manner similar to the capital structure calculated in Avista's recent rate proceedings?**

A. Yes, with certain updates. This methodology considers debt and equity outstanding for our Avista Utilities regulated business, including the impact of costs related to the issuance of that debt and equity. We have included a short-term debt balance of \$100 million, which represents approximately 3.22 percent of our overall capital structure. The \$100 million in short-term debt represents the forecast average balance of short-term debt during 2016 (the period when rates would become effective).

In recent rate proceedings our capital structure calculation considered the impact of our former subsidiary, Ecova. The Ecova impact is completely removed since Ecova was sold in mid-2014.

The capital related to AERC and its subsidiary, AEL&P, does not impact the capital structure calculation for the Avista Utilities' rate proceeding. Debt and equity for AERC, which was acquired in mid-2014, are excluded from this calculation for Avista Utilities.



1           **Q.     How does the Company determine the amount of long-term debt, short-**  
2 **term debt and common equity to be included in its capital structure?**

3           A.     As a regulated utility, Avista has an obligation to provide safe and reliable  
4 service to customers while balancing fiscal safety and economy, in both the short term and  
5 long term. Through our planning process, we determine the amount of new financing  
6 needed to support our capital expenditure programs while maintaining an optimal capital  
7 structure that balances and supports our current credit ratings and provides flexibility for  
8 anticipated future capital requirements.

9           **Q.     Why is the Company proposing a 48 percent equity ratio?**

10          A.     On December 31, 2014, Avista's common equity percentage for the  
11 Washington jurisdiction was 51.2%. The Ecova and AERC business unit transactions I  
12 described in Section III contributed to a higher equity level. I also explained the share  
13 repurchase program we implemented in 2014 to gradually reduce the level of equity;  
14 however, the program expired with only 63% of the repurchase goal achieved. We also  
15 changed the dividend reinvestment program: shareholders electing to reinvest dividends  
16 now obtain Avista shares purchased from the market rather than newly issued shares.

17          The Company continues to evaluate the extent and timing of equity issuances for  
18 2015, taking into account our capital expenditures and the second share repurchase program  
19 that is operating in the first quarter of 2015. These steps to manage our equity level are  
20 expected to result in a common equity level of approximately 48% for 2016.

21          Maintaining a 48 percent common equity ratio has several benefits for customers.  
22 We are dependent on raising funds in capital markets throughout all business cycles. These  
23 cycles include times of contraction and expansion. Lower leverage implies lower financial

1 risk of a company. This implied reduced risk will assist us in accessing capital markets on  
2 reasonable terms when there are disruptions in the financial markets.

3           Additionally, a 48 percent common equity ratio solidifies our current credit ratings  
4 and moves us closer to our long-term goal of having a corporate credit rating of BBB+. A  
5 rating of BBB+ would be consistent with the natural gas and electric industry average,  
6 which I will further explain later in my testimony. We rely on credit ratings in order to  
7 access capital markets on reasonable terms. Moving further away from non-investment  
8 grade (BB+) provides more stability for the Company, which is also beneficial for  
9 customers. We believe our requested 48 percent equity appropriately balances safety and  
10 economy for customers.

11           **Q. In attracting capital under reasonable terms, is it necessary to attract**  
12 **capital from both debt and equity investors?**

13           A. Yes, it is absolutely essential. As a publicly traded company we have two  
14 primary sources of external capital: debt and equity investors. As of December 31, 2014, we  
15 had approximately \$2.9 billion of debt and equity. Approximately half of our capital  
16 structure is funded by debt holders and the other half is funded by equity investors and  
17 retained earnings. Rating agencies and potential debt investors tend to place significant  
18 emphasis on maintaining strong financial metrics and credit ratings that support access to  
19 debt capital markets under reasonable terms. Leverage – or the extent that a company uses  
20 debt in lieu of equity in its capital structure – is a key credit metric and, therefore, access to  
21 equity capital markets is critically important to long-term debt investors. This emphasis on  
22 financial metrics and credit ratings is shared by equity investors who also focus on cash  
23 flows, capital structure and liquidity, much like debt investors.

1           The level of common equity in our capital structure can have a direct impact on  
2 investors' decisions. A balanced capital structure allows us access to both debt and equity  
3 markets under reasonable terms on a sustainable basis. Being able to choose specific  
4 financing methods at any given time also allows the Company to take advantage of better  
5 choices that may prevail as the relative advantages of debt or equity markets can ebb and  
6 flow at different times.

7           **Q.     Are the debt and equity markets competitive markets?**

8           A.     Yes. Our ability to attract new capital, especially equity capital, under  
9 reasonable terms is dependent on our ability to offer a risk/reward opportunity that is equal  
10 to or better than the equity investors' other alternatives. We are competing with not only  
11 other utilities but also with businesses in other sectors of the economy. Demand for our  
12 stock supports our stock price, which provides us the opportunity to issue additional shares  
13 under reasonable terms to fund capital investment requirements.

14          **Q.     What is Avista doing to attract equity investment?**

15          A.     We are requesting a capital structure that provides us the opportunity to have  
16 financial metrics that offer a risk/reward proposition that is competitive and attractive for  
17 equity holders.

18          We have steadily increased our dividend for common shareholders over the past  
19 several years to work toward a dividend payout ratio that is comparable to other utilities in  
20 the industry. This is an essential element in providing a competitive risk/reward opportunity  
21 for equity investors.

22          Tracking mechanisms, such as the Energy Recovery Mechanism and Purchased Gas  
23 Adjustment approved by the regulatory commissions, help balance the risk of owning and

1 operating the business in a manner that places us in a position to offer a risk/reward  
2 opportunity that is competitive with not only other utilities, but with businesses in other  
3 sectors of the economy.

4

5

**VII. PROPOSED RATE OF RETURN**

6

**Q. Has Avista prepared an exhibit that includes the components of Avista's  
7 requested rate of return of 7.46 percent?**

8

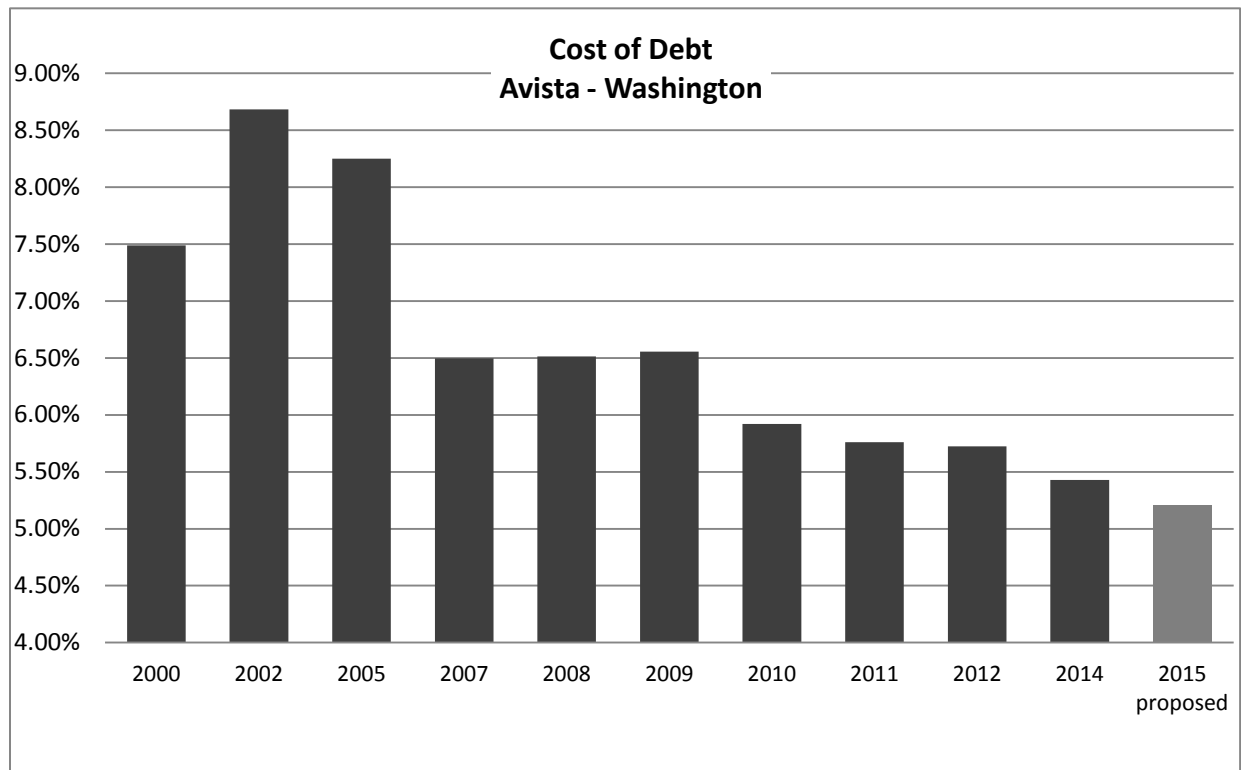
A. Yes. Exhibit No.\_\_\_\_(MTT-2) shows the components of Avista's requested  
9 rate of return of 7.46 percent.

10

**Q. What is the Company's overall cost of debt, and how does the  
11 Company's current overall cost of debt compare to its historic cost?**

12

A. Our requested overall cost of debt is 5.20 percent. The cost of debt has  
13 trended downward for Avista from 2000 to 2014, as shown in Illustration No. 4 below.

**Illustration No. 4**

**Q. Please explain why Avista’s cost of long-term debt has continued to decrease.**

A. There has been a general decline in interest rates for several years while Avista has issued new debt, causing the Company’s overall cost of debt to decrease. We have been prudently managing our interest rate risk in anticipation of these periodic debt issuances, which has involved fixed rate long-term debt with varying maturities, and executing forward starting interest rate swaps to mitigate interest rate risk on a portion of the future maturing debt and our overall forecasted debt issuances.

From 2011 through 2014 we issued \$315 million in long-term debt. The weighted average rate of these issuances is 3.30 percent. These issuances have varying maturities ranging from 3 years to 35 years, and a weighted average maturity of 23.6 years.

1           Our most recent issuance (in 2014) was \$60 million of first mortgage bonds with a  
2 thirty year maturity at a rate of 4.11%. This new debt, which matures in 2044, is the lowest  
3 priced debt with a term beyond twenty years that the Company has issued since the 1950s.  
4 The effective cost of this debt is even lower at 3.65%, which includes cost of issuance and  
5 the impact of interest rate hedges. The \$5.4 million positive value of the interest rate hedges  
6 (hedges were settled when the coupon rate was set) improved the effective yield on this debt  
7 by 0.52%. I will discuss the interest rate hedging program later in my testimony.

8           The prior year (in 2013) we issued \$90 million of three-year debt (maturing in 2016)  
9 at a very favorable rate of 0.84%. The effective cost of this debt is a negative 0.04%, which  
10 includes cost of issuance and the impact of interest rate hedges. We received \$2.9 million  
11 for settled interest rate hedges, which improved the effective yield on this debt by 1.07%.

12           We have continued to issue debt with varying maturities to balance the cost of debt  
13 and the weighted average maturity. This practice has provided us with the ability to take  
14 advantage of historically low rates on both the short end and long end of the yield curve.

15           The Company's credit ratings have remained above the low end of the investment-  
16 grade position on rating agency scales for the last several years, which has supported  
17 reasonable demand for Avista debt by potential investors. We have further enhanced credit  
18 quality and reduced interest cost by issuing debt that is secured by first mortgage bonds.  
19 Our recurring capital investments in utility property sustain and support advantageous first  
20 mortgage bonds as a financing alternative.

21           We plan to continue issuing long-term debt with various maturities for the  
22 foreseeable future in order to fund our capital expenditure program and long-term debt  
23 maturities.

1           **Q.     What is the Company doing to mitigate interest rate risk related to**  
2 **future long-term debt issuances?**

3           A.     Our future borrowing requirements are primarily driven by our significant  
4 capital expenditure program and maturing debt, which creates exposure to interest rate risk.  
5 As mentioned earlier, we are forecasting \$1.8 billion in capital expenditures over the next  
6 five years.  Additionally, we have \$452.5 million of debt maturing during the same period.  
7 We are forecasting the issuance of over \$900 million in long-term debt from 2015 through  
8 2019 to fund these capital expenditures and maturing debt while maintaining an appropriate  
9 capital structure.

10           We usually rely on short-term debt as interim financing for capital expenditures, with  
11 issuances of long-term debt in larger transactions approximately once a year.  As a result, we  
12 access long-term debt capital markets on limited occasions, so our exposure to prevailing  
13 long-term interest rates can occur all at once rather than across market cycles.  To mitigate  
14 interest rate risks, we hedge the rates for a portion of forecasted debt issuances over several  
15 years leading up to the date we anticipate each issuance.

16           We also manage interest rate risk exposure by limiting the extent of outstanding debt  
17 that is subject to variable interest rates rather than fixed rates.  In addition, we issue fixed  
18 rate long-term debt with varying maturities to manage the amount of debt that is required to  
19 be refinanced in any period (looking ahead to its future maturity), and to obtain rates across  
20 a broader spectrum of prevailing terms which tend to be priced at different interest rates.

21           **Q.     Does the Company have guidelines regarding its interest rate risk**  
22 **management?**

1           A.     Yes. The Company's Interest Rate Risk Management Plan, attached as  
2 Confidential Exhibit No.\_\_\_\_(MTT-3C), is designed to provide a certain level of stability to  
3 future cash flows and the associated retail rates related to future interest rate variability. The  
4 plan provides guidelines for hedging a portion of interest rate risk with financial derivative  
5 instruments. We settle these hedge transactions for cash simultaneously when a related new  
6 fixed-rate debt issuance is priced in the market. The settlement proceeds (which may be  
7 positive or negative) are amortized over the life of the new debt issuance.

8           The interest rate risk management plan provides that hedge transactions are executed  
9 solely to reduce interest rate uncertainty on future debt that is included in the Company's  
10 five-year forecast. The hedge transactions do not involve speculation about the movement  
11 of future interest rates.

12           **Q.     Is the cost of short-term debt the Company seeks to recover in this**  
13 **proceeding consistent with the approach in its most recent general rate case?**

14           A.     Yes, the calculated cost of short-term debt includes credit facility availability  
15 fees, interest on amounts borrowed, amortization of upfront costs, and forecasted LIBOR  
16 rates. The result is a short-term debt cost of 2.04 percent, as shown in Exhibit  
17 No.\_\_\_\_(MTT-2) page 4.

18           **Q.     Please describe Avista's credit facility.**

19           A.     We have a five-year credit facility in the amount of \$400 million with a  
20 maturity date of April 2019. The credit facility involves participation by ten banks. This  
21 credit facility was originally established in 2011 and it was amended in April 2014. Our  
22 credit facility provides the ability to take out short-term debt based on day-to-day liquidity  
23 needs and to have letters of credit issued on the Company's behalf. The Company pays fees



1 under three price elements in the agreement: 1) a facility fee to maintain the right to draw  
2 on the credit facility at any time, 2) interest on amounts borrowed, and 3) fees for letters of  
3 credit.

4 The Company may request letters of credit (LCs) underwritten by the participating  
5 banks and established for the benefit of counterparties to Avista. LCs are often used as  
6 collateral when required for energy resources forward commitments, forward swap  
7 transactions to hedge interest rate risk on future long-term debt, and other contractual or  
8 legal requirements that involve the Company. The maximum available for LCs is \$200  
9 million. The amount available for cash borrowing out of the overall \$400 million credit  
10 facility is reduced by the amount of LCs outstanding.

11 Illustration No. 5 below summarizes the rates paid to maintain and use the credit  
12 facility.

13

1 **Illustration No. 5**

2

Pricing Level	Facility Fee	Eurodollar Margin (1)	ABR Margin (2)	LC Participation Fee
I	0.075%	0.675%	0.000%	0.675%
II	0.100%	0.775%	0.000%	0.775%
III	0.125%	0.875%	0.000%	0.875%
IV	0.175%	0.950%	0.000%	0.950%
V	0.200%	1.050%	0.050%	1.050%
VI	0.250%	1.250%	0.250%	1.250%

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Borrowing may be either of two types of short-term loans at the Company's discretion:

(1) Borrowing with a Eurodollar-based interest rate requires three days notice. Interest rate is based on the London interbank offered rate (LIBOR) plus a margin.

(2) Borrowing under the alternative borrowing rate (ABR) may be completed on the day requested. ABR interest rate is the prime rate set by the administrative agent bank plus a margin.

11 The Pricing Level and associated rates that we are charged is based upon our

12 underlying credit ratings as well as the security supporting the borrowings. Our current rates

13 are based upon Pricing Level II, which became effective in February 2014 based on the

14 Company's improved credit ratings. We achieve this Pricing Level by securing the credit

15 facility with First Mortgage Bonds. If we did not secure this credit facility with First

16 Mortgage Bonds, the costs would be based on Pricing Level IV, which would increase costs

17 to customers. There are also upfront costs paid for setting up the credit facility (i.e. legal

18 arrangement, bank commitments) that are amortized over the term of the credit facility.

19 **Q. The Company is requesting a 9.9% return on equity. Please explain why**

20 **the Company believes this is reasonable.**

21 A. We agree with the analyses presented by Mr. McKenzie which demonstrate

22 that the proposed 9.9 percent ROE, together with the proposed equity layer of 48%, would

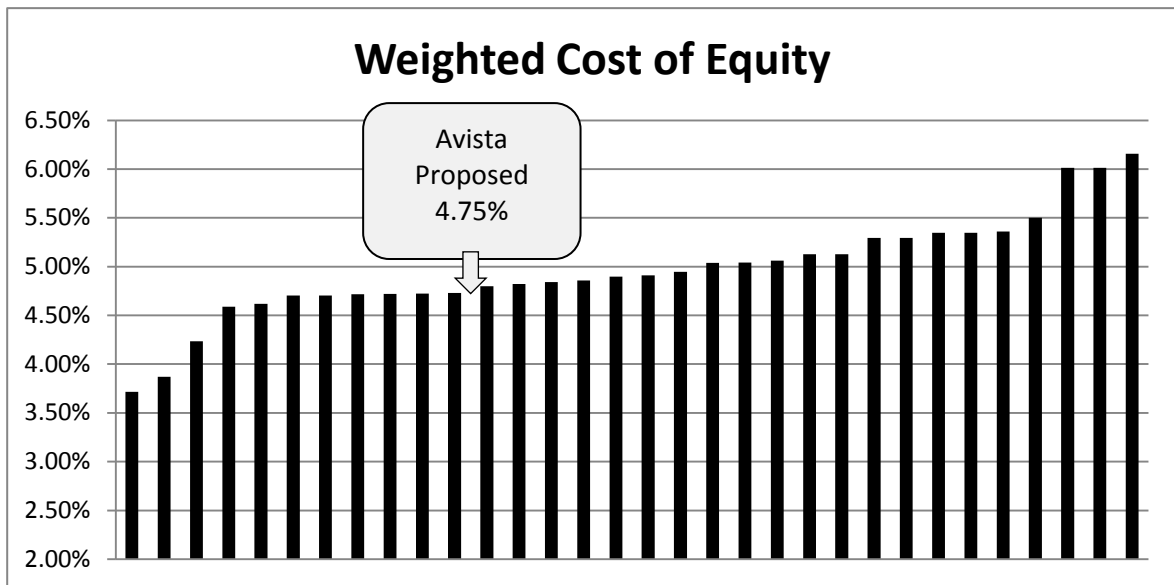
23 properly balance safety and economy for customers, provide Avista with an opportunity to

1 earn a fair and reasonable return, and provide access to capital markets under reasonable  
 2 terms and on a sustainable basis. The proposed weighted cost of equity is 4.75% (9.9%  
 3 times 48%).

4 **Q. How does Avista’s requested 4.75 percent weighted cost of equity**  
 5 **compare with the weighted cost of equity recently approved for electric and natural**  
 6 **gas utilities in other jurisdictions?**

7 A. The bar chart in Illustration No. 6 below shows the weighted cost of equity  
 8 approved by state regulators for investor-owned utilities across the country, for the six-  
 9 month period from July 1, 2014 through December 31, 2014. These data in the bar chart  
 10 represent all of the commission decisions that specify an ROE and equity ratio for utilities in  
 11 this six-month period.

12 **Illustration No. 6<sup>2</sup>**



21 Avista’s proposed weighted cost of equity of 4.75 percent, which is also shown in  
 22 the chart above, is below the middle of the range of these weighted cost of equity numbers.

<sup>2</sup> Source – SNL Financial, Rate Cases finalized July 1, 2014 through December 31, 2014.

1 Additional details related to this chart, including the names of the utilities, are provided in  
2 Exhibit No.\_\_\_\_(MTT-4).

3 Because Avista competes with other utilities for equity investor dollars, it is  
4 important for Avista to be able to provide an earnings opportunity that is competitive with  
5 other utilities.

6

7

### **VIII. CREDIT RATINGS**

8 **Q. How important are credit ratings for Avista?**

9 A. Utilities require ready access to capital markets in all types of economic  
10 environments. The capital intensive nature of our business with energy supply and delivery  
11 dependent on costly long-term projects to fulfill our obligation to serve customers  
12 necessitates the ability to obtain funding from the financial markets under reasonable terms  
13 at regular intervals. In order to have this ability, investors need to understand the risks  
14 related to any of their investments. Financial commitments by our investors generally  
15 stretch for many years – even decades – and the potential for volatility in costs (arising from  
16 energy commodities, natural disasters and other causes) is a key concern to them. To help  
17 investors assess the creditworthiness of a company, nationally recognized statistical rating  
18 organizations (rating agencies) developed their own standardized ratings scales, otherwise  
19 known as credit ratings. These credit ratings indicate the creditworthiness of a company and  
20 assist investors in determining if they want to invest in a company and its comparative level  
21 of risk compared to other investment choices.

1 **Q. Please summarize the credit ratings for Avista.**

2 A. Avista' credit ratings, assigned by Standard & Poor's (S&P) and Moody's  
3 Investor Service (Moody's) are as follows:

	<b>S&amp;P</b>	<b>Moody's</b>
<b>Senior Secured Debt</b>	A-	A2
<b>Corporate Credit Rating</b>	BBB	Baa1
<b>Outlook</b>	Stable	Stable

4  
5  
6  
7 Additional information on our credit ratings has been provided on page 1 of Exhibit  
8 No. \_\_\_\_ (MTT-2).

9 **Q. Please explain the implications of the credit ratings in terms of the**  
10 **Company's ability to access capital markets.**

11 A. Credit ratings impact investor demand and expected returns. More  
12 specifically, when we issue debt, the credit rating can affect the determination of the interest  
13 rate at which the debt will be issued. The credit rating can also affect the type of investor  
14 who will be interested in purchasing the debt. For each type of investment a potential  
15 investor could make, the investor looks at the quality of that investment in terms of the risk  
16 they are taking and the priority they would have for payment of principal and interest in the  
17 event that the organization experiences severe financial stress. Investment risks include, but  
18 are not limited to, liquidity risk, market risk, operational risk, and credit risk. These risks  
19 are considered by S&P, Moody's and investors in assessing our creditworthiness.

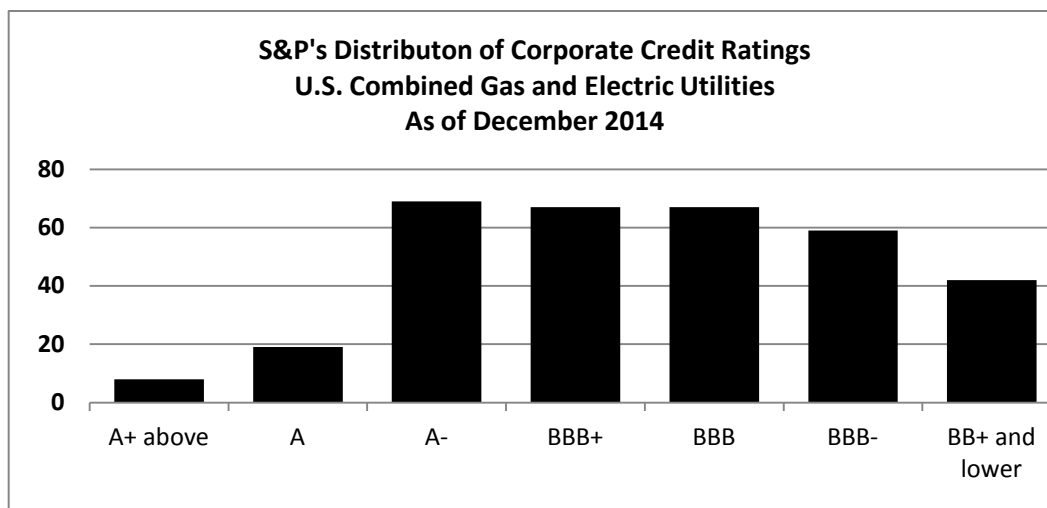
20 In challenging credit markets, where investors are less likely to buy corporate bonds  
21 (as opposed to U.S. Government bonds), a stronger credit rating will attract more investors,  
22 and a weaker credit rating could reduce or eliminate the number of potential investors.

1 Thus, weaker credit ratings may result in a company having more difficulty accessing  
2 capital markets and/or incurring significantly higher costs when accessing capital.

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

4 A. Avista believes operating at a corporate credit rating level of BBB+ is more  
5 appropriate. As shown in Illustration No. 7 below, the average credit rating for U.S.  
6 Regulated Combined Gas and Electric Utilities is BBB+.

7 **Illustration No. 7**



15 We expect that a continued focus on the regulated utility, conservative financing  
16 strategies and a supportive regulatory environment will contribute toward an upgrade to a  
17 BBB+ corporate credit rating for Avista. Operating with a BBB+ credit rating would likely  
18 attract additional investors, lower our debt pricing for future financings, and make us more  
19 competitive with other utilities. In addition, financially healthy utilities are better able to  
20 invest in the required infrastructure over time to serve their customers, and to withstand the  
21 challenges facing the industry and disruptions in the financial market.

22 **Q. How important is the regulatory environment in which the Company**  
23 **operates?**

1           A.     Both Moody’s and S&P cite the regulatory environment in which a regulated  
2 utility operates as the dominant qualitative factor to determine a company’s  
3 creditworthiness. Moody’s rating methodology is based on four primary factors. Two of  
4 those factors – a utility’s “regulatory framework” and its “ability to recover costs and earn  
5 returns” – make up 50 percent of Moody’s rating methodology<sup>3</sup>.

6           S&P states the following<sup>4</sup>:

7           Regulation is the most critical aspect that underlies regulated integrated  
8 utilities’ creditworthiness. Regulatory decisions can profoundly affect  
9 financial performance. Our assessment of the regulatory environments in  
10 which a utility operates is guided by certain principles, most prominently  
11 consistency and predictability, as well as efficiency and timeliness. For a  
12 regulatory process to be considered supportive of credit quality, it must limit  
13 uncertainty in the recovery of a utility’s investment. They must also  
14 eliminate, or at least greatly reduce, the issue of rate-case lag, especially  
15 when a utility engages in a sizable capital expenditure program.

16           Because of the major capital expenditures planned by Avista and future maturities of  
17 long-term debt, a supportive regulatory environment is essential in maintaining our current  
18 credit rating.

19           **Q.     Does this conclude your pre-filed direct testimony?**

20           A.     Yes.

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<sup>3</sup>Moody’s Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, December 23, 2013.

<sup>4</sup>Standard and Poor’s, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.