

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-07 _____

DOCKET NO. UG-07 _____

DIRECT TESTIMONY OF

MALYN K. MALQUIST

REPRESENTING AVISTA CORPORATION

I. INTRODUCTION

1
2 **Q. Please state your name, business address, and present position with Avista**
3 **Corp.**

4 A. My name is Malyn K. Malquist. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corporation as Executive Vice
6 President and Chief Financial Officer.

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

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

11 I joined Avista in September of 2002 as Senior Vice President. In November 2002 I was
12 named to the additional position of Chief Financial Officer. I was named Executive Vice
13 President in May 2006. Prior to joining Avista, I was General Manager of Truckee Meadows
14 Water Authority in Reno, Nevada, which was separated out from Sierra Pacific Power Company
15 in 2001. I was Chief Executive Officer of Data Engines, Inc., a high tech company located in
16 Reno from June to October of 2000. From April 1994 to April 2000, I was employed by Sierra
17 Pacific Resources, first as the company's Chief Financial Officer and later as its Chairman of the
18 Board and Chief Executive Officer. Following the merger of Sierra Pacific Resources with
19 Nevada Power Company in 1999, I became the President of both Sierra Pacific Power Company
20 and Nevada Power Company. For the sixteen-year period prior to 1994, I was employed by San
21 Diego Gas & Electric Company in various positions, including Treasurer and Vice President –
22 Finance.

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

2 A. I will provide a financial overview of the Company and will explain the overall
3 rate of return proposed by the Company in this filing for its electric and natural gas operations.
4 The proposed rate of return is derived from Avista Utilities' costs of debt (including short-term
5 debt, long-term debt and trust preferred securities), and common equity, weighted in proportion
6 to the proposed capital structure.

7 I will address the proposed capital structure and debt cost components. Witness Avera
8 will testify to the appropriate return on equity for the Company.

9 In brief, I will provide information that shows:

- 10 • We have been aggressively rebuilding our financial health by improving our cash flow,
11 managing our costs and paying down debt. Since 2001 the Company has repurchased
12 approximately \$325 million of its higher-cost debt.
13
- 14 • We have been strategically reducing our involvement in our unregulated subsidiaries.
15
- 16 • Although the electric and natural gas deferral balances have declined in recent years, the
17 Washington electric and natural gas deferral balances at February 28, 2007 are \$66.5 million.
18 Recovery of these balances would lead to lower debt, higher interest coverage ratios and a
19 stronger financial condition for the Company.
20
- 21 • In addition, major capital expenditures are planned for 2007-2008 of approximately \$355
22 million for customer growth, investment in generation, transmission and distribution facilities
23 for the electric utility business as well as necessary maintenance and replacements of our
24 natural gas utility systems. Avista needs adequate cash flow from operations to fund these
25 requirements.
26
- 27 • Avista's corporate rating from Standard & Poor's is currently BB+, which is below
28 investment grade. Avista Utilities should operate at a level that will support a strong
29 investment grade credit rating, meaning at least a strong "BBB" or weak "A". The
30 Company's financial performance has improved since 2001, however, we have not improved
31 financial ratios to a level that would regain an investment grade rating and the Company does
32 not expect to do so until at least 2008.
33

- 1 • The Company has proposed an overall rate of return of 9.39%, including a 47.78% equity
2 ratio and an 11.3% return on equity. In this case, although we believe an ROE greater than
3 11.3% is supported and is warranted, as testified by witness Avera, we also believe the 11.3%
4 provides a reasonable balance of the competing objectives of regaining financial health
5 within a reasonable period of time, and the impacts that increased rates have on our
6 customers.

7
8 An improved credit rating to investment grade is only likely if the Company's financial
9 strength and its outlook improve for a sustained period of time. The Company's initiatives to
10 carefully manage its operating costs and capital expenditures are an important part of improving
11 performance, but are not sufficient without revenues from the general rate request for our electric
12 and natural gas businesses in these cases. Certainty of cash flows from operations can only be
13 achieved with the continued support of regulators in allowing the timely recovery of costs and the
14 ability to earn a fair return on investment.

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

16 A. Yes. I am sponsoring Exhibit No. ____ (MKM-2) pages 1 and 2, which were
17 prepared under my direction. Avista's credit ratings by the three principal rating agencies are
18 summarized on page 1, and Avista's actual capital structure at December 31, 2006 and pro forma
19 capital structure at December 31, 2007 are included on page 2.

20
21 **II. FINANCIAL OVERVIEW**

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

23 A. Although the Company has made good progress in improving its financial health
24 in recent years, Avista's credit ratings remain below investment grade and are anticipated to
25 remain there until at least 2008. During the energy crisis of 2000 and 2001, it was necessary for

1 the Company to issue a significant amount of debt to cover electric and natural gas costs incurred
2 but not yet paid for by Avista's customers. These costs were deferred for future recovery under
3 the accounting treatment approved by the Commission. These deferred electric and natural gas
4 costs reached over \$340 million in 2001 on a system basis. The electric deferrals were driven
5 primarily by the combination of record-low hydroelectric conditions and unprecedented high
6 wholesale market prices that occurred in 2001.

7 During that time investors and lenders were reluctant to invest in the utility industry,
8 including Avista, and were demanding higher interest rates. Much of the debt issued by Avista
9 during this time was at rates exceeding 9%. As a result, Avista's annual interest costs rose from
10 approximately \$69 million in 2000 to over \$105 million in 2001 and 2002. In addition, Avista's
11 debt ratio (including long-term debt to affiliated trusts) rose to over 64% by December 2001 and
12 the amount of debt outstanding (including long-term debt to affiliated trusts) rose from \$825
13 million in January 2000 to \$1,353 million at December 31, 2001.

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

15 A. We have been aggressively rebuilding our financial health by improving our cash
16 flow, managing our costs, and debt structure. Since 2001, and through the fourth quarter of
17 2006, the Company has repurchased approximately \$325 million of higher-cost debt.

18 In December 2006, S&P affirmed its corporate credit rating of BB+ with a stable outlook
19 for Avista. The S&P rating and outlook has been maintained since December 2002. In
20 December 2006, Moody's affirmed its corporate credit rating of Ba1 with a stable outlook for
21 Avista. The Moody's rating and outlook has been maintained since March 2004. In August
22 2006, Fitch ratings revised the credit rating outlook for Avista to positive from stable.

1 On April 16, 2007, Avista Energy (an indirect subsidiary of Avista Corp.) signed a
2 definitive agreement to sell substantially all of its contracts and ongoing operations. Over time,
3 Avista Corp. plans to redeploy the majority of the proceeds from the transaction into its regulated
4 utility operations by reducing debt and investing in capital assets. Rating agencies have viewed
5 this as a positive credit development. In fact, S&P changed the Company's outlook to positive
6 from stable. However, rating agencies have indicated that continued regulatory support as well
7 as sustained improvement in financial metrics will be critical to improving the Company's credit
8 ratings. In a recent research update regarding Avista Corp, Standard & Poor's stated "Avista
9 Corp's ratings trajectory will depend not only on the sale of Avista Energy but also on a
10 meaningful improvement in the Company's financial profile, which is not expected before
11 2008." Additionally, in the same research update, Standard & Poor's stated "Continued
12 regulatory support will also be an important consideration."¹

13 Although we are making progress in improving the Company's financial condition, we
14 are still not as strong as we need to be, which is why the rating agencies are not yet ready to
15 upgrade our credit rating. Typically, the rating agencies would first place us on "Positive
16 Outlook" about one year prior to an actual upgrade. Furthermore, there is additional review
17 required by the rating agencies when a company's upgrade involves a "cross-over" (i.e. a change
18 from non-investment grade to investment grade rating).

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¹ Standard & Poor's, *Research Update: Avista Corp's Rating Outlook Revised to Positive on Announced Intent to Sell Avista Energy* (April 17, 2007).

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

2 A. The Company is continuing to rebuild its financial condition in three areas. First,
3 we are working to assure we have adequate funds for operations, capital expenditures and debt
4 maturities, through lines of credit with our banks and maintaining adequate access to the capital
5 markets. We have worked with our banks to insure that we have adequate liquidity through the
6 availability of our credit facility on the most economic basis possible. Additionally, the
7 Company plans to obtain a portion of our capital requirements through equity issuance. The
8 Company issued 3.2 million shares of common stock in December 2006. We also maintain an
9 ongoing dialogue with the rating agencies regarding the measures being taken by the Company to
10 regain an investment grade credit rating.

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

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

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

2 **Q. Please explain the ratings for Avista’s debt and other securities, and the**
3 **implications of these ratings in terms of the Company’s ability to access financial markets.**

4 A. Avista’s credit ratings by the three principal rating agencies are summarized on
5 page 1 of Exhibit No. ____ (MKM-2). For each type of investment a potential investor could
6 make, the investor looks at the quality of that investment in terms of the risk they are taking and
7 the priority that they would have in the event that the organization experiences severe financial
8 stress. Investment risks include the likelihood that a company will not meet all of its debt
9 obligations in terms of timeliness and amounts owed for principal and interest. Secured debt
10 receives the highest ratings and priority for repayment and, hence, has the lowest relative risk.

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

13 A. Among the risk factors are the level and volatility of wholesale electric market
14 prices and natural gas prices for fuel costs, liquidity in the wholesale market (fewer
15 counterparties and tighter credit restrictions), recoverability of natural gas and power costs,
16 streamflow and weather conditions, changes in legislative and governmental regulations, security
17 concerns related to terrorism, relicensing hydro projects and availability of funding.

18 Higher capital expenditures for environmental compliance and new generation are also
19 impacting the utility sector. The significant need for capital expenditures causes increased
20 competition for financial capital. Regulation supporting the full and timely recovery of prudently
21 incurred costs will be critical to the utility sector, including Avista.

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

2 A. Avista Utilities should operate at a level that will support a strong investment
3 grade credit rating, meaning at least a “BBB+” or an “A-,” using S&P’s rating scale. Prior to
4 2001, Avista’s credit rating was in the A-/BBB+ range. Ratios required to support this level of
5 credit rating are included in Table 1 below. This Commission has historically recognized that
6 financially healthy utilities have lower financing costs which, in turn, benefits customers. In
7 addition, financially healthy utilities are better able to invest in the needed infrastructure over
8 time to serve their customers, and to withstand the challenges and risks facing the industry.

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 access to
11 capital markets under reasonable terms. Access is more difficult and more expensive for non-
12 investment grade companies. In many instances, investors are precluded by law, regulation, or
13 policy from investing in non-investment grade securities. As new financing is required in the
14 future to finance utility plant additions, new customer additions, and debt maturities, the cost of
15 new and replacement debt will be higher for a non-investment grade issuer.

16 Non-investment grade companies are also subject to more restrictive credit requirements
17 from vendors and other counterparties. In fact, the Company’s ability to purchase power and
18 natural gas has been impacted by its below-investment grade rating, and there are fewer
19 counterparties willing to do business with us. The lower credit rating also requires the Company
20 to post more collateral with counterparties than would otherwise be required with a higher credit
21 rating. This results in increased costs. It also reduces financial flexibility since we must always
22 maintain a certain amount of capacity under our credit line for letters of credit.

1 **Q. What are the credit rating ratios used by the rating agencies?**

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

| Standard & Poor's Financial Ratio Benchmarks* | | | | | | |
|--|---------------|--------------|--------------|--------------|-----------------|----------|
| Table 1 | | | | | | |
| Ratio | AA | A | BBB | BB | Avista (BB+) ** | |
| | | | | | Unadjusted | Adjusted |
| Fund from operations/interest coverage (x) | 5.2 - 6.0 (x) | 4.2 - 5.2(x) | 3.0 - 4.2(x) | 2.0 - 3.0(x) | 3.4 (x) | 2.5 (x) |
| Funds from operations/total debt (%) | 35 - 45% | 28 - 35% | 18 - 28% | 12 - 18% | 19.2% | 13.0% |
| Total debt/total capital (%) | 32 - 40% | 40 - 48% | 48 - 58% | 58 - 62% | 53.7% | 57.6% |
| <i>BBB = investment grade credit rating</i> | | | | | | |
| <i>* Ranges for companies with a Business Profile of "6", which includes Avista Corp. Includes adjustments made by S&P</i> | | | | | | |
| <i>** As of 12/31/06</i> | | | | | | |

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6 **Q. Please describe how these ratios are calculated and what they mean?**

7 A. The first ratio, "Funds from operations/interest coverage (x)", calculates the
8 amount of cash from operations that is available to cover interest requirements. The second
9 ratio, "Funds from operations/total debt (%)", calculates the amount of cash from operations as a
10 percent of total debt, and the third ratio, "Total debt/total capital (%)", is the amount of debt in
11 our total capital structure. S&P looks at many other financial ratios, however, these are the three
12 most important ratios they use when analyzing our financial profile.

1 **Q. Do rating agencies make adjustments to the financial ratios that are**
2 **calculated directly from the financial statements of the Company?**

3 A. Yes. Rating agencies make adjustments to debt to factor in off-balance sheet
4 commitments (for example, the accounts receivable program, purchased power agreements and
5 the unfunded status of pension and other post-retirement benefits) that negatively impact the
6 ratios. The adjusted financial ratios for Avista are included in Table 1 above.

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

8 As of December 31, 2006, for the first ratio, "Fund from operations/interest coverage",
9 Avista's ratio is 3.40x unadjusted. The adjusted ratio is 2.5x which is not within the 3.0-4.2 range
10 needed to meet a BBB rating. As discussed previously, progress in increasing this ratio to meet
11 the investment grade level has been slower than anticipated due to below normal stream flows
12 affecting hydro generation, higher thermal fuel costs than the amount included in rates, and
13 higher capital expenditures that require cash up front before we can recover the costs from
14 customers. Each has an impact on the Company by reducing the amount of available cash flow
15 from operations, requiring external financing and ultimately resulting in higher debt and lower
16 interest coverage ratios.

17 Avista's position as of December 31, 2006, for the second ratio, "Funds from
18 operations/total debt" is 19.2% unadjusted. The adjusted ratio is 13.0% compared to the 18%-
19 28% needed for investment grade.

20 Avista's rating as of December 31, 2006, for the third ratio, "Total debt/total capital" is
21 53.7% unadjusted. The adjusted ratio is 57.6% compared to 48-58% needed for investment
22 grade.

1 In order to move each adjusted ratio within the required range to meet investment grade
2 requirements, Avista must reduce its total debt balances and increase its available funds from
3 operations. Although the Company has continued to work towards paying down its total debt,
4 the negative impacts to cash flow caused by below-normal hydroelectric generation and volatility
5 of wholesale electric market prices and natural gas prices in recent years, has adversely affected
6 Avista's ability to reduce total debt. In addition, although we have reduced our Washington
7 electric and natural gas deferral balances, the balances remain at \$66.5 million at February 28,
8 2007. The deferral balances are also an area that concerns the rating agencies.

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

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

16 **Q. How important is the regulatory environment in which a Company**
17 **operates?**

18 A. According to my discussions with the rating agencies, the regulatory environment
19 in which a company operates is a major factor in determining a company's creditworthiness. In a
20 recent article published by S&P entitled "Top Ten Credit Issues Facing U.S. Utilities", S&P
21 stated that "the regulatory and political dynamic will remain the most important determinant of

1 credit quality.”² As explained further by Mr. Avera, given investors’ heightened awareness of the
2 risks associated with the electric power industry and the damage that results when a utility’s
3 financial flexibility is compromised, supportive regulation is more crucial now than at any time
4 in the past.

5 Although Avista has electric and natural gas tracking mechanisms (ERM and PGA) to
6 provide recovery of the majority of the variability in commodity costs, these changes in costs
7 must be financed until the costs are recovered from customers. As noted above, investors and
8 rating agencies are concerned about regulatory lag and cost-recovery. Company witness Mr.
9 Norwood discussed in his direct testimony the Company’s proposal for a Power Cost Only Rate
10 Case (PCORC), which would allow the Company to file with the Commission to update its base
11 power supply and transmission-related revenues and expenses between general rate cases.
12 Regulatory approval of a PCORC would help Avista recover costs timely (in an era of rising
13 costs) and will assist the Company in earning its authorized return. Additionally, regulatory
14 approval of a PCORC would help address the investment community’s and rating agencies’
15 concerns related to the risks of rising costs.

16 17 **IV. CASH FLOW**

18 **Q. What are the Company’s near-term capital requirements?**

19 A. As a combination electric and natural gas utility, over the next few years capital
20 will be required for customer growth, investment in generation, transmission and distribution

² Standard & Poor’s, *Top Ten Credit Issues Facing U.S. Utilities* (January 29, 2007).

1 facilities for the electric utility business, as well as necessary maintenance and replacements of
2 our natural gas systems.

3 The amount of capital expenditures planned for 2007-2008 is approximately \$355
4 million. For 2007 alone, these costs equate to a total of \$183 million. Total net rate base at
5 December 31, 2006 was \$1.6 billion for the total Company; therefore, these planned capital
6 additions represent substantial new investments. A few of the major capital expenditure items
7 for 2007 include \$60 million for electric transmission and distribution upgrades, \$38 million for
8 electric and natural gas customer growth, \$20 million for natural gas system upgrades, \$11
9 million for environmental (associated with the Spokane River relicensing and the 2001 Clark
10 Fork River license implementation issues), and \$20 million for generation upgrades.

11 Avista's Integrated Resource Plan has identified the potential need for the Company to
12 finance significant expenditures for electric facilities. The preferred strategy outlined in our 2005
13 Integrated Resource Plan included total expenditures of \$1.5 billion by 2016, including
14 investment in wind resources and upgrades at hydroelectric stations. The need for additional
15 generating resources has not gone away since 2005. In fact, many of the cost components
16 inherent in our capital budget have continued to increase rapidly. Examples of this are the cost
17 of steel, cement, asphalt, and transformers.

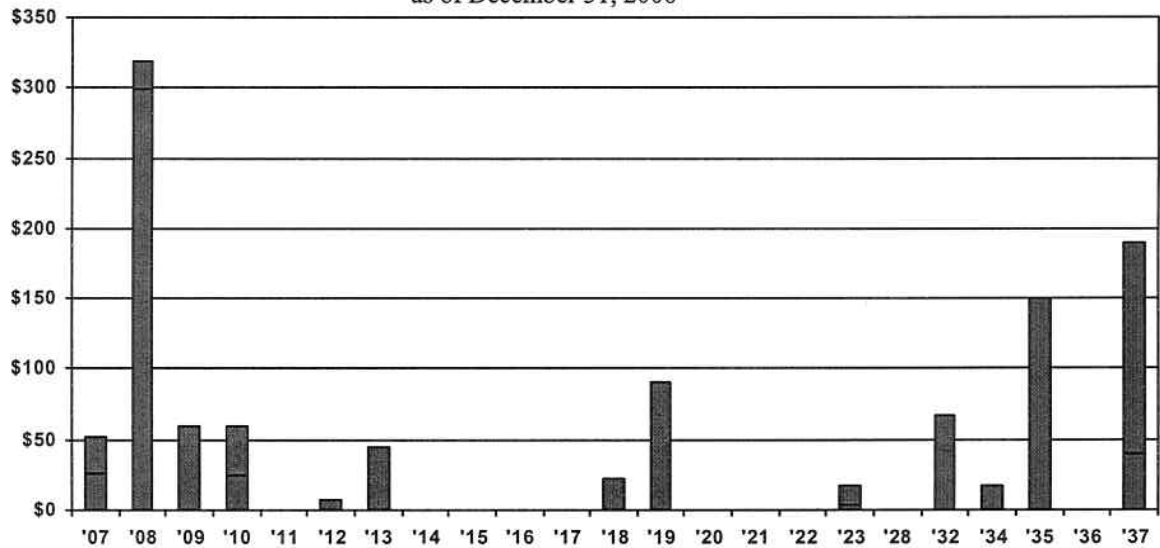
18 Major capital expenditures are a normal part of utility operations. Customers are added to
19 the service area, roads are relocated and require existing facilities to be moved, and facilities
20 continue to wear out and need replacement. These and other requirements create the need for
21 significant capital expenditures each year. In addition, we are seeing significant increases in the
22 costs of materials. Access to capital at reasonable rates is dependent upon the Company

1 maintaining a strong capital structure, sufficient interest coverages, and investment grade credit
 2 ratings.

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

4 A. The Company had 47% (i.e., over \$520 million) of its total debt maturing in 2007
 5 and 2008. In December 2006, the Company issued \$150 million of debt. The \$150 million of
 6 new debt issuance is due in 2037 and replaced debt that was due January 1, 2007. The December
 7 2006 refinancing has been reflected in the chart below and in our proposed cost of debt. After
 8 considering the December 2006 refinancing, the Company has approximately 34% of its total
 9 debt maturing in 2007 and 2008, with the majority maturing in 2008. The debt due in 2008 is
 10 directly related to the 2001 energy crisis. A stronger credit rating would likely allow the
 11 Company to refinance the 2008 debt maturities at lower interest rates. Therefore, it is important
 12 for the Company to improve its financial condition and increase its credit ratings quickly, which
 13 will result in lower financing costs for customers in the future.

14 **Future Debt Maturities by Year**
 15 as of December 31, 2006



1 **Q. Has the Company taken any steps to address the significant debt maturities it**
2 **faces in 2008?**

3 A. Yes it has. The Company has repurchased, when economic, \$127 million of
4 9.75% debt that is due in 2008. Additionally, as a result of the historically low interest rate
5 environment that existed in 2004, the Company entered into two forward-starting interest rate
6 swaps totaling \$125 million or almost 45% of the 2008 debt maturities. The swaps have contract
7 terms of ten years beginning in 2008. These agreements secured a fixed rate for a significant
8 portion of the total future interest rate. These agreements do not lock in Avista's credit spread;
9 therefore, the Company could realize lower financing costs as a result of improved credit ratings.
10 We also had a \$75 million interest rate swap for debt that matured in 2007.

11 **Q. What other financing activities did the Company complete in 2004 through**
12 **2006 that will lower its interest costs?**

13 A. The Company refinanced \$60 million of 7.875% Trust Preferred Stock in April
14 2004 at a rate of 6.50% through April 2009. In addition, the Company issued First Mortgage
15 Bonds in the amount of \$90 million at 5.45% with a 15-year maturity, \$150 million at 6.25%
16 with a 30-year maturity, and \$150 million at 5.70% with a 30.5-year maturity, in November
17 2004, November 2005 and December 2006, respectively. Cost of total debt has decreased from
18 8.44% at December 31, 2003 to 7.74% at December 31, 2006. The Company also issued 3.2
19 million shares of common stock in December 2006.

20

21

1 **Q. Are there other changes to Avista's debt portfolio that you would like to**
2 **discuss?**

3 A. Yes, in 2005 Avista chose to terminate the lease for the Rathdrum CT and
4 purchased the plant. In 1993, WP Funding LP was formed by Avista Corporation to finance the
5 natural gas-fired combustion turbine generating facility (Rathdrum CT) in Rathdrum, Idaho. The
6 financing was structured as an operating lease for book purposes, and a capital lease for tax
7 purposes, which resulted in lower overall project financing costs. Avista completed construction
8 of the project and placed it into service in 1995.

9 Beginning on December 31, 2003, new accounting and reporting rules (FIN 46) required
10 the Company to consolidate WP Funding LP into the Company's consolidated financial
11 statements. As a result, the Rathdrum CT and related debt were required to be recorded on the
12 Company's balance sheet, and the related depreciation and interest expense were required to be
13 recorded within the consolidated income statement (i.e., the amount of debt reflected on the
14 Company's balance sheet increased). This new consolidation requirement eliminated the
15 benefits of the original financing structure. Avista terminated the lease arrangement and
16 purchased the facility in September 2005. The acquisition of the plant did not change the manner
17 in which the plant is used to serve customers.

18 **Q. How do the Company and its customers benefit from the termination of the**
19 **Rathdrum CT lease and purchase of the facility?**

20 A. Terminating the lease was in the financial best interest of Avista's customers,
21 because the lease costs were higher than interest costs for Company-issued debt securities. This
22 was primarily due to the lease having a 25 basis points charge for administration and 60 basis

1 points charge for the equity return component of the lease. The estimated annual savings from
2 these charges is approximately \$311,000 net of tax. From a consolidated perspective, the
3 Company replaced \$56.3 million of WP Funding LP debt and third party-investment with lower
4 cost borrowings by Avista Corporation. In simple terms, since the new accounting required the
5 lease costs to be reflected on the balance sheet as debt, it was reasonable to use the lowest cost
6 debt available to finance the project. No pro forma adjustments have been made to the 2006 data
7 related to the Rathdrum CT purchase, as the transaction was completed in 2005 and fully
8 reflected in the 2006 results.

9 **Q. What is the status of the Company's line of credit secured by first mortgage**
10 **bonds?**

11 A. The facility has been sized to allow the Company to fund at least one year of
12 capital expenditures, plus required working capital and counterparty collateral requirements to
13 assure flexibility given both the volatile financial markets and volatile energy commodity prices.

14 Many purchases of natural gas, or contracts for pipeline capacity to provide natural gas
15 transportation, have required collateral, and/or prepayments, given the Company's credit rating.
16 The line of credit is our primary source of immediate cash for borrowing to meet these needs and
17 for supporting the use of letters of credit. These cash needs are also met through the Company's
18 receivables purchase agreement. A line of credit is required to manage daily cash flow since the
19 timing of cash receipts versus cash disbursements is never totally balanced.

20 Prior to December 2004, the line of credit had a term of 364 days. In December 2004, we
21 were able to extend the maturity to five years and lower our financing costs. In April 2006, the
22 Company amended its corporate line of credit, lowering the borrowing costs, extending the term

1 again to five years and lowering the total line to \$320 million (from \$350 million). The
2 Company has the option of increasing the line by \$100 million (up to \$420 million) at any time
3 during the term of the agreement. The agreement includes the option to release the first
4 mortgage bond security if the Company regains its investment grade credit rating. This
5 demonstrates recognition by our banks that Avista's financial condition is improving.

6 **Q. What are Avista's plans regarding common equity and why is this**
7 **important?**

8 A. Avista needs to continue to improve the common equity ratio of its capital
9 structure. As mentioned earlier, the company partially accomplished this through equity issuance
10 (the Company issued 3.2 million shares in December 2006). The sale of Avista Energy and the
11 redeployment of the majority of those funds in the utility business will also improve the utility
12 equity layer. It is important to the rating agencies who rate the Company's securities, and hence
13 an important component of the Company's cost of doing business, for Avista to have a more
14 balanced debt/equity ratio in order to minimize the risk of default on required debt interest
15 payments.

16 **Q. What is the status of the Company's progress in meeting the prior**
17 **commitment to increase the equity layer at the Utility?**

18 A. The Company has agreed to increase the utility equity component to 35% by the
19 end of 2007 and 38% by the end of 2008. Failure by Avista Utilities to meet those targets could
20 result in a reduction of base rates of 2% for each target. We have also entered into a settlement
21 agreement in Washington related to our proposed holding company formation, which was
22 approved in Docket No. U-060273. In that settlement agreement, we have committed to increase

1 the utility equity component to 40% by June 30, 2008. Should we fail to meet the 40% equity
2 ratio, Avista Utilities has agreed to use the most current actual utility equity ratio (rather than a
3 hypothetical ratio) in the next general rate case filed after June 30, 2008. The provision to reduce
4 base rates by 2 percent does not apply if we fail to meet this target. The utility equity component
5 was 38.1% as of December 31, 2006, an increase of 7% from the year-end 2005 ratio. As
6 discussed above, Avista Corp. plans to redeploy the majority of the proceeds from the Avista
7 Energy transaction into its regulated utility operations by reducing debt and investing in capital
8 assets. This will increase the utility equity component and result in the consolidated and utility
9 only equity being substantially the same.

10 Avista expects to remain at or above the current equity level, and thus will meet the
11 required equity ratios required at the end of 2008, assuming normal weather and water
12 conditions. The more flexibility the Company has by maintaining access to both the debt and
13 equity markets, the stronger our financial condition will become. The opportunity to earn our
14 allowed return on equity will continue to build the equity ratio, and improve the Company's
15 financial condition. It is also important to have a higher common equity ratio in the event
16 adverse conditions exist.

17 **Q. What are Avista's plans regarding preferred equity?**

18 A. Avista had \$26.25 million of preferred equity outstanding as of December 31,
19 2006. The entire amount of the preferred equity matures in September 2007. Currently, Avista
20 does not have plans to issue additional preferred equity. Avista will continue to evaluate the
21 appropriateness of preferred equity within its overall capital structure.

1 **V. CAPITAL STRUCTURE**

2 **Q. Please explain the capital structure proposed by Avista in this case.**

3 A. Avista's current capital structure consists of a blend of long-term debt, short-term
4 debt, trust preferred securities, preferred equity and common equity necessary to support the
5 assets and operating capital of the Company. The proportionate shares of Avista Corp.'s actual
6 capital structure on December 31, 2006, are shown on page 2 of Exhibit No. __ (MKM-2). A pro
7 forma capital structure is also shown in the Exhibit, which reflects expected changes for the
8 period ending December 31, 2007. Supporting workpapers provide additional details related to
9 these adjustments.

10 The rate of return to be applied to rate base in this proceeding is equal to the weighted
11 average cost of capital, taking into account the pro forma adjusting items. As shown on page 2
12 of Exhibit No. __ (MKM-2), Avista Utilities is proposing an overall rate of return of 9.39%.

13
14 **VI. COST OF DEBT**

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

16 A. Cost of debt in the Company's proposed capital structure includes both long-term
17 and short-term debt and trust preferred securities. As shown on page 2 of Exhibit No.
18 __ (MKM-2), the actual weighted average cost of total debt outstanding on December 31, 2006
19 was 7.74%. The size and mix of debt funding changes over time based upon the actual financing
20 completed. We have made certain pro forma adjustments to update the debt cost through
21 December 31, 2007 to 7.70%. Pro forma adjustments to long-term debt reflect expected

1 maturities of outstanding debt. The pro forma weighted cost of total debt was reduced from
2 3.67% to 3.66%.

3 The level of short-term debt is based on the amount outstanding at the end of the
4 respective period. The cost of short-term debt is based on our costs of borrowing under our
5 corporate credit facility along with a forward curve of short-term LIBOR rates. This estimated
6 forward curve is based on information accessed through Thomson One market information.

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VII. COST OF COMMON EQUITY

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

11 A. The company is proposing an 11.3% return on common equity (ROE),
12 representing the lower end of Dr. Avera's recommended range of required return on equity. Dr.
13 Avera testifies to analyses related to the cost of common equity for a benchmark group of utilities
14 in the western U.S., with an ROE range of 11.3% to 12.3%. In his testimony Dr. Avera states
15 that:

16 Considering investors' expectations for capital markets and the need to
17 support financial integrity and fund crucial capital investment even
18 under adverse circumstances, it is my opinion that 11.8 percent is a
19 reasonable ROE for Avista. (P. 4, L. 8)

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1 **Q. Dr. Avera suggests that an ROE of 11.8% is reasonable. Why is Avista**
2 **not requesting an ROE greater than 11.3%?**

3 A. As I have testified, the Company has made progress in its efforts to regain
4 financial health. If Avista can earn an 11.3% ROE in 2008, I believe the financial results should
5 support a stronger bond rating within a reasonable period of time.

6 Furthermore, as the Company has worked toward improving its financial condition over
7 the last several years, it has done so with the customer in mind. Avista has attempted to balance
8 the time frame for financial recovery with the impacts that increased retail rates have on its
9 customers.

10 In this case, although we believe an ROE greater than 11.3% is supported and is
11 warranted, we also believe the 11.3% provides a reasonable balance of the competing objectives
12 of improving our financial condition within a reasonable period of time, and the impacts that
13 increased rates have on our customers.

14 **Q. Please summarize the proposed capital structure and the cost components for**
15 **debt and common equity.**

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

| PRO FORMA | | | | |
|--|-------------------------------|-------------------------------------|-------------|---------------------|
| Cost of Capital as of December 31, 2007 | <u>Amount</u> | <u>Percent of Total Capital</u> | <u>Cost</u> | <u>Component</u> |
| Total Debt | \$1,016,418,053 | 47.54% | 7.70% | 3.66% |
| Trust Preferred Securities | 100,000,000 | 4.68% | 7.04% | 0.33% |
| Common Equity | <u>1,021,679,943</u> | <u>47.78%</u> | 11.30% | <u>5.40%</u> |
| TOTAL | <u><u>\$2,138,097,996</u></u> | <u><u>100.00%</u></u> | | <u><u>9.39%</u></u> |

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3 **Q. Has Avista considered the impact of the Company's current or future electric**
4 **and natural gas tracking mechanisms on the requested return on equity?**

5 A. Yes, the Company has considered the impact that the current electric Energy
6 Recovery Mechanism (ERM) and natural gas Decoupling mechanism, and the proposed impact
7 from the Company's requested PCORC, would have on the Company's requested return on
8 equity. My discussions with investors and rating agencies indicate that these types of
9 mechanisms are viewed favorably by the investment community; however, this has not changed
10 their views on Avista's overall investment risk or return on equity. Witness Avera also indicates
11 that these mechanisms have been favorably received by the investment community, however, he
12 notes that there is no indication that these changes will lead to any measurable decline in Avista's
13 overall investment risks or ROE. Witness Avera further discusses the expected impact within his
14 testimony.

15 **Q. Does that conclude your pre-filed direct testimony?**

16 A. Yes.